A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 23, 1965, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Hayes, Vice Chairman
Mr. Balderston
Mr. Daane
Mr. Ellis
Mr. Galusha
Mr. Maisel
Mr. Mitchell
Mr. Patterson
Mr. Robertson
Mr. Scanlon
Mr. Shepardson

Messrs. Bopp, Hickman, Clay, and Irons, Alternate Members of the Federal Open Market Committee

Messrs. Wayne, Shuford, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Young, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Baughman, Garvy, Holland, Koch, and Willis, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Solomon, Adviser to the Board of Governors
Mr. Molony, Assistant to the Board of Governors
Mr. Cardon, Legislative Counsel, Board of Governors
Mr. Partee, Associate Director, Division of Research and Statistics, Board of Governors
Messrs. Garfield and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Hersey, Adviser, Division of International Finance, Board of Governors
Mr. Axilrod, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Eaton, General Assistant, Office of the Secretary, Board of Governors

Messrs. Eastburn, Mann, Parthemos, Brandt, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Philadelphia, Cleveland, Richmond, Atlanta, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. MacLaury, Assistant Vice President, Federal Reserve Bank of New York
Mr. Geng, Manager, Securities Department, Federal Reserve Bank of New York
Mr. Kareken, Consultant, Federal Reserve Bank of Minneapolis

Upon motion duly made and seconded, and by unanimous vote, the minutes of the meetings of the Federal Open Market Committee held on November 2 and 4, 1965, were approved.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period November 2 through November 17, 1965, and a supplemental report for November 18 through 22, 1965. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. MacLaury said the Treasury was still debating whether to show a $50 million decline in the gold stock this week. The best indications at the moment were that in the absence of any renewed selling by the Russians during the next few weeks there would have to be a total reduction in the stock before the end of the year of perhaps $100 million. The question was simply one of timing. In the London gold market there

had been no unusual developments during the recent period; the price had remained in roughly a 3 cent range from $35.10-13, and the gold pool was on balance unchanged from the beginning of the month.

The exchange markets had likewise been generally quiet, except for some fluctuations in the Canadian dollar. Sterling was at about the same levels spot and forward as at the beginning of the month. There was some pressure on sterling at the time of the Rhodesian declaration of a state of emergency on November 5, but as it turned out the limited selling associated with that political development only served to reestablish the rate at more easily defensible levels. Despite the quiet appearance of the pound market, the Bank of England had continued to make good progress in improving its exchange position this month; it had probably taken in close to $400 million from the market since November 1. A sizable part of that would be used to pay off maturing forwards, but a portion would also be used for repayment of short-term debts. It was expected that the $125 million swap drawing scheduled to mature on Friday, November 26, would be paid off at that time, thus reducing outstanding British drawings to $475 million and at the same time reestablishing their first-line credit facility in case it should be needed at some point in the future.

Mr. MacLaury noted that the Canadian dollar was quoted above $0.93 during the early part of the month but dropped rather sharply

when the market learned on November 9 that the U.S. and Canadian Governments had agreed to cooperate in seeking postponement until 1966 of delivery on a number of Canadian bond issues scheduled for the U.S. market during the remaining weeks of the year. The reaction, though fairly sharp, was short-lived, and the Canadian authorities had to provide only modest support before the rate turned around again, helped by bidding for U.S. funds by Canadian finance companies. Though the discount on the forward Canadian dollar was substantial (3/4 per cent), it still left an incentive of between a quarter and a half per cent on a comparison of finance paper rates in the two markets.

Trading in continental currencies had been quite well balanced during the month, with only minor fluctuations in rates. The System Account had been able to make further progress in paying down the drawing under the swap arrangement with the Swiss National Bank; only $14 million equivalent remained outstanding and it was hoped to have that completely liquidated before the usual year-end repatriation of funds by Swiss banks began to put pressures on the National Bank's holdings. The only other change in the System's position under the swap arrangements during the period was the drawing of the remaining $10 million equivalent of Belgian francs under the standby portion of the facility with the National Bank of Belgium to absorb dollars taken in by that Bank.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the System open market transactions in foreign currencies during the period November 2 through 22, 1965, were approved, ratified, and confirmed.

Mr. MacLaury then presented several recommendations. He noted that two swap facilities were scheduled to mature during December: the $100 million equivalent arrangement with the Netherlands Bank, with a term of 3 months, would mature December 15; and the $100 million arrangement with the National Bank of Belgium, with a term of 12 months, would mature December 22. He recommended renewal of both of those arrangements.

Renewal of the two swap arrangements was approved.

The $50 million equivalent fully drawn portion of the Belgian National Bank arrangement was also scheduled to mature December 22, Mr. MacLaury said, and he recommended its renewal for another 6 months. The System's balances under this fully drawn portion were unutilized and thus available in case of need.

The recommended renewal was noted without objection.

Mr. MacLaury then referred to a memorandum on System participation in forward lira operations, distributed to the Committee under date of November 18, 1965, in which Mr. Coombs, Special Manager of the System Open Market Account, recommended that the Federal Reserve participate with the Treasury in taking over from the Italian Exchange

Office forward lira commitments and suggested certain implementing changes in the Guidelines for System Foreign Currency Operations and the continuing authority directive for such operations. (A copy of the memorandum has been placed in the files of the Committee.)

Mr. MacLaury said Governor Carli of the Bank of Italy had requested that the U.S. authorities assume additional commitments in the amount of $500 million equivalent. As the Committee knew, the Treasury now had outstanding $1 billion equivalent of such commitments. The recommendation of Mr. Coombs for System participation in the operation was not prompted by an unwillingness on the part of the Treasury to extend its commitments further--clearly, if there had been any question on the part of the Treasury as to the usefulness of the operation, it would never have allowed its participation to reach present levels. Rather, it was felt that the Federal Reserve should itself be associated directly with the Italian authorities in their efforts to minimize the potentially disruptive effects of their large surplus on international financial markets and the U.S. gold stock. There was no need to dwell on the consequences for the U.S. and the rest of the world if Italy had followed the example of France during the past year. Instead, the Bank of Italy had consistently taken the initiative in seeking ways to strengthen the international financial system without undercutting the position of the dollar; insulating the system from the shocks of the sharp Italian payments

swings had been an important contribution in that direction. Indeed, had the Italian authorities not channeled such a sizable volume of funds into the Euro-dollar market this past year, it seemed quite likely that the resulting strains would have required Federal Reserve intervention on a far larger scale than in fact was necessary. It seemed far preferable, therefore, that the Federal Reserve encourage the type of constructive policies being pursued by the Bank of Italy by associating itself with them rather than, in effect, find itself forced into salvage operations by the absence of such policies.

As for the System's exposure to risk in taking on forward lira commitments, Mr. Coombs' memorandum had pointed out that the terms of the arrangement precluded any losses resulting from a revaluation of the lira, from exchange rate fluctuations within the existing margins, or from failure to deliver on the part of an Italian commercial bank. Indeed, except in the case of a devaluation of the dollar vis-a-vis the lira, the U.S. would never have to acquire lire to pay off maturing contracts since it was agreed that the contracts would be taken over again by the Italian authorities at the time of their final liquidation by the Italian commercial banks.

Mr. MacLaury emphasized that the Committee, if it approved the recommendation that the System take on forward lira contracts in conjunction with the Treasury, would not be venturing into new

areas or departing from previous policies. Except for the lesser risks involved, the Italian forward operation was not different in nature from other operations previously undertaken by the Federal Reserve. Only a minor change would be required in the Guidelines for System Foreign Currency Operations to authorize forward exchange transactions that would indirectly (i.e., by backing up the Bank of Italy) as well as directly supplement market supplies of forward cover to encourage retention or accumulation of dollar holdings by private foreign holders.

There followed a discussion in which Mr. MacLaury responded to several questions bearing generally on how the proposed System operation would work in terms of the various parties involved, including the Federal Reserve, the Italian Exchange Office, and the Italian commercial banks. In the course of his explanation, Mr. MacLaury brought out that the System would in effect be providing a guarantee to the Exchange Office against devaluation of the dollar. This was the type of guarantee the System gave when it drew under swap arrangements; it was not a gold guarantee.

Mr. Scanlon asked whether the forward contracts would be for 3 months or more, and Mr. MacLaury replied that they would be for a period of not more than 3 months. Mr. Scanlon then asked whether it could not be anticipated that they would have to be rolled over, to which Mr. MacLaury replied that they probably would be rolled over

until there was some change in the Italian payments picture.
Mr. Scanlon commented that he agreed completely that the Italians should be encouraged to continue to do what they had been doing. But he questioned whether the proposed operation did not amount to getting into the longer-run area, and if so whether this would not require a broader amendment than had been suggested in the Guidelines for Foreign Currency Operations.

Mr. Daane remarked that much would depend on the Italian payments position, which could shift very rapidly, as it had in the past. Meantime, it quite clearly served the U.S. interest to give the Italian commercial banks an incentive to hold dollars and avoid a drain on gold, particularly when there was no risk involved. While this was an operation that could not be pinpointed from a time standpoint, he did not think one could say it was definitely an operation of long duration, assuming the Italians continued their efforts to move back to payments equilibrium.

Mr. Scanlon reiterated that he was not in disagreement with the proposal. He was merely raising the question whether the Guidelines did not require some broader revision than proposed.

Mr. Maisel said it appeared to him that a major change in the whole concept of System foreign currency operations was involved, which change the Committee was being asked to approve on an ad hoc basis. If there was no great urgency, he felt that the proposition

should be turned back to the staff for re-examination in the light of the overall question. It seemed to him the Committee should not change its policies by acting on propositions that were brought before it one at a time on short notice.

Mr. Daane said the type of operation currently being proposed would represent no departure from precedent from the Treasury standpoint, for the Treasury had initiated such operations in 1962. Nor did he believe that it would represent in principle any shift in policy from the Committee's standpoint. The principle seemed to him clear. It amounted to protecting the U.S. gold stock and assisting a country that had been trying to be helpful to the U.S. It was his understanding that the Italian authorities had come to the U.S. authorities with a request, and he felt that action should not be deferred.

Mr. Mitchell asked whether, if the proposal was considered basically desirable, the Committee should not get down to the issues. He understood that the System would not be giving a guarantee different from what it had previously given in connection with swap operations. It would not be giving a gold guarantee, only a guarantee in terms of the lira. If so, the remaining question related to the duration of the operation. Mr. Scanlon might have a point in saying that there should be some broader modification of the Guidelines to accommodate an operation of this kind. Under the swaps, drawings were generally limited to 3 months, with at most 3 extensions if necessary.

Mr. MacLaury commented that although one could not foresee exactly how long this kind of operation might be required, there was no reason to believe that the Treasury would be unwilling to take another look if the Committee felt at some future date that the operation was running on too long for a System operation.

Mr. Hickman suggested that at the end of a year the Treasury might be asked to take over, and Mr. Daane said he felt sure that if at some point the Committee decided it was in the interest of the System to get out, the Treasury would be willing to provide a takeout, particularly since there was no risk involved.

Mr. MacLaury observed that the Treasury had provided a takeout on a small number of occasions when the Committee felt that swap drawings had run on longer than desirable.

Mr. Shepardson asked whether the System operation would be in addition to what the Treasury was doing, and Mr. MacLaury replied in the affirmative. The Treasury now had taken over $1 billion equivalent of forward lira commitments. If the System took on the proposed $500 million, the total taken over by the Treasury and the System would be $1.5 billion. Mr. Shepardson then asked whether, at the end of a year, if the Committee decided it wanted to get out the Treasury would take over the $500 million, and Mr. MacLaury said he felt sure it would. He reiterated that Mr. Coombs' recommendation that the System become involved was not based on any reluctance on the part of the Treasury to extend its commitments further.

Mr. Shepardson then said that although he was not objecting to the proposed procedure, it was not entirely clear to him why, if the Treasury had been doing this and would have no objection to increasing its commitments, the System should step in.

Mr. Hayes commented that the Committee had tried to move in parallel with the Treasury on most foreign currency operations, except where they were clearly long-term operations at the outset. As to the current proposal, there was no way of knowing at the outset how long an operation would be involved. However, judging from past experience the Italian balance of payments tended to involve swings of major propostions within fairly short periods, so there was a good chance of the proposed operation being a short-term self-liquidating proposition. Starting with that as a possibility, it made a lot of sense for the System to participate in partnership with the Treasury. It would fit in with the kind of operation the System had been conducting by means of the swap arrangements. The System would retain the opportunity to go to the Treasury and ask it to take over if the operation became a drag on the System, just as that privilege had been retained right along in connection with transactions under the swap arrangements.

Mr. Daane noted that the operation clearly had the aspects of a central bank cooperative venture. From the Italian standpoint, it would enable the Bank of Italy to avoid getting into an embarrassing position by having too high a dollar ratio in its reserve

position. The operation was a central bank-to-central bank gesture and thus was quite clearly within the purview of the System.

Mr. Mitchell remarked that it was essentially a substitute for a swap--and in his opinion a much more desirable relationship. It was one that not too many other foreign countries presumably would go along with. But he felt the Guidelines probably should contain some recognition of the potential duration and some kind of limitation. He suggested 9 months or a year as a time limit. Mr. Shepardson pointed out that the Committee had fixed a limit of a year on swap drawings remaining outstanding.

Chairman Martin remarked that he saw no objection to so changing the Guidelines. He did not think it essential, however, because this was an experimental operation.

Mr. Mitchell inquired whether, if the Committee approved Mr. Coombs' proposal, this would make it possible to enter into similar undertakings with countries other than Italy, or with the Italians again, and Mr. Young pointed out that the recommended change in the continuing authority directive was directed solely to the lira arrangement. Mr. MacLaury commented that the proposed minor change in the Guidelines did not prejudge in any way whether the Committee would wish to conduct this kind of operation again with the Italians, or any other country. As Mr. Young had indicated, the recommended change in the continuing authority directive was

stated entirely in terms of the lira, but that directive could, of course, be revised at a later time if the Committee so desired.

Mr. Mitchell repeated that he thought this method of operation was preferable to the swap arrangement, and that it should be encouraged if any other country was willing to go along.

Mr. MacLaury said he would be reluctant to agree that it was a preferable method of operation. It was a viable alternative in this particular instance, but the System had used a number of operating techniques, all of which were potentially valuable, and any one of which might have special advantages in a particular situation.

Mr. Hayes commented that if there was another case where it appeared desirable that a transaction similar to the Italian operation be entered into, that would have to be brought before the Committee, and Mr. Maisel said this was precisely the point about which he was concerned. It seemed to him that the Committee's policies should be thought out logically in advance. He was not going to dissent from the current proposal, especially in light of the reported pressure of time. But he considered it important that the Committee get some staff views on where it was going in the longer run in foreign currency operations, and on the relationships between various types of operations, so it would not be called upon to react to one proposal after another on an ad hoc basis. Adding one authority after another was a poor way of doing business.

Chairman Martin then suggested approving the current proposition and asking the staff to give the Committee a memorandum on the broader subject, and there appeared to be general agreement with this suggestion.

Mr. Hayes commented, however, that he did not think the Committee had been acting on an ad hoc basis to the degree Mr. Maisel's remarks suggested, following which Mr. Ellis commented that he thought it would be appropriate to distinguish between what the New York Bank was directed to do and what it was authorized to do. The language of the continuing authority directive said the Bank was both authorized and directed to do various things. In the present case, in the absence of legal considerations with which he was not familiar, he thought all that was really needed was to authorize the Bank to operate in the manner proposed.

Mr. Young brought out that the language proposed for the lira arrangement would be consistent with that found in other paragraphs of the continuing authority directive. However, the point raised by Mr. Ellis could be reviewed by the Committee's Counsel before the continuing authority directive came up for reaffirmation by the Committee next March.

Mr. Daane then suggested that, in view of the questions raised by Mr. Maisel and Mr. Ellis, the staff take a complete look before the March meeting at the Guidelines and authorities covering System foreign currency operations.

Chairman Martin proposed proceeding on that basis, and no objection was heard.

> Thereupon, upon motion duly made and seconded, and by unanimous vote, paragraph 2 of section 4 of the Guidelines for System Foreign Currency Operations was amended to read as follows, effective immediately:

When it is deemed appropriate to supplement existing market supplies of forward cover, directly or indirectly, as a means of encouraging the retention or accumulation of dollar holdings by private foreign holders.

> Upon motion duly made and seconded, and by unanimous vote, the following paragraph was added to the continuing authority directive for foreign currency operations:

The Federal Reserve Bank of New York is also authorized and directed to assume commitments for forward sales of lire up to $500 million equivalent as a means of facilitating the retention of dollar holdings by private foreign holders.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering open market operations in U.S. Government securities and bankers' acceptances for the period November 2 through 17, 1965, and a supplemental report for November 18 through 22, 1965. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes commented as follows:

The past three weeks have been interesting ones for those of us on the Trading Desk. As you will recall we started out the period after the last Committee meeting with a fairly poor reception of the Treasury's November refunding operation, with even keel considerations well

to the fore. Before that statement week was over we ran into the power blackout, which also blacked out any real knowledge as to where the New York money market banks stood with respect to their reserve positions or where the System stood with respect to nationwide reserve availability. Following the blackout--but with no causal connection--we had some recovery in the Government bond market and, for the first time since I became Manager of the System Open Market Account, a statement week--the week ending November 17--in which we conducted no operations in Government securities.

The reserve statistics have of course swung rather widely as a result of the November 9 power blackout in the northeast. Despite a swing from free reserves of about $100 million in the week ending November 10 to net borrowed reserves of about $200 million in the week ending November 17, the money market has been more consistently firm than one might have expected. Federal funds traded predominantly at 4-1/8 per cent on every day except one, when a 3-1/2 per cent effective rate prevailed. As the written reports explain more fully, the disruption in bank operations caused by the blackout made the free reserve figure a meaningless one. By the same token, the large reserves carried over into the November 17 week by the New York City banks were absorbed by the fall in over-all reserve availability and a buildup in excess reserves at country banks. The chief visible result of the gyrations in reserve statistics was the recovery in average member bank borrowings from the Reserve Banks from $334 million in the first full statement week of the period to a more normal $489 million in the second.

Over the period Treasury bill rates have edged a bit higher, but it is well to remember that the market has taken on $6.5 billion tax bills in the past two months. The market has functioned smoothly and dealers have had sufficient confidence in the viability of existing rate levels--and in System needs to supply reserves over the next few weeks--to build up substantially their portfolios of Treasury bills, including bills put out on repurchase agreements maturing over the December dividend and tax dates. The Treasury's auction of $2.5 billion June tax anticipation bills last Tuesday proceeded uneventfully, and the sale of the bills by the banks that bought them through the tax and loan accounts to the dealers has been progressing without difficulty. In yesterday's auction a good interest was evident with the 3- and 6-month bills going at about 4.10 and 4.25

per cent, respectively. Early bidding ideas for today's auction of one-year bills are in a range of 4.25 - 4.27 per cent.

Prices of Treasury notes and bonds declined to the lowest levels of the year in the early part of the recent period as a result of the rapid buildup of the calendar of new corporate offerings and the lukewarm reception given the Treasury's November refinancing. The initial market reaction to the results of the refunding was moderated by purchases of the new 4-1/4 per cent note for Treasury accounts. The new issue itself held up well thereafter, and System purchases of the when-issued securities--discussed at the special November 4 telephone meeting of the Committee--were not required. Subsequently, a better atmosphere developed as the large volume of new corporate issues attracted a generally more favorable response, and at somewhat lower rates, than had earlier been expected. Some market participants were also impressed by the Administration's success in rolling back the aluminum price, and the implications of this for monetary policy. Many market observers continue to expect, however, that yields are likely to work higher over the months ahead. Although the tone in the corporate market improved, yields on municipal bonds rose irregularly throughout the interval. While dealers in the bond markets have been encouraged to some degree by the recent performance, the markets still remain susceptible to sudden changes in sentiment in response to changing conditions.

Perhaps a word is in order about the special pressures that typically focus on the banks and the money market over the coming mid-December period. Bankers, Government securities dealers, and other participants in the short-term market are of course well aware of these special pressures, although they realize that the degree of pressure can vary considerably from year to year. Given the greatly enhanced importance of certificates of deposit, a great deal of attention is being focused on the problems that the commercial banks face over the forthcoming period of tax and dividend payments and simultaneous peak credit demands. New York banks are now generally offering rates of 4-1/2 per cent for 3-month CD maturities, and banks generally appear to be stepping up their efforts to place unsecured promissory notes at rates that are above the Regulation Q ceilings for certificates of deposit.

> Despite tensions and uncertainties, particularly with regard to the ability of the banks to compete for funds, the market appears to be generally confident that December--barring any sudden upsurge in credit demands--will not bring undue stresses and strains. Reliance is being placed in part on a high level of cash flow of the automobile companies, and in part on expectations of an absence of any sharp change in capital market conditions. But the market is mainly relying on the Federal Reserve--through open market operations--to make at least the customary provisions for the special demands of the period of peak pressure just ahead.
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> As far as the Treasury financing schedule is concerned, the November refunding can now be considered to be pretty much out of the way. Payment for the second instalment of June tax anticipation bills is due on Wednesday, and as noted earlier there have been no problems thus far in the distribution of these bills. The Treasury will have to be back in the market again in January, with the likelihood that a cash financing covering at least part of January needs will be announced before the end of this year.

Mr. Hickman referred to Mr. Holmes' comment that the November Treasury refunding could now be considered pretty much out of the way. Yet payment was not due until tomorrow on the tax anticipation bills, and presumably the distribution of the bills would go on for a week or more.

Mr. Holmes replied that many banks had sold the bills on a when-issued basis. Thus, a good part of the distribution had been completed. There appeared to be no great pressure for distribution of the remaining bills.

Asked about dealer positions, Mr. Holmes said they had been built up quite substantially in the belief that the Federal Reserve would be in the market to buy at least $1 billion of securities in order to accommodate seasonal reserve needs.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the open market transactions in Government securities and bankers' acceptances during the period November 2 through 22, 1965, were approved, ratified, and confirmed.

The staff economic and financial report today was in the form of a visual-auditory presentation. (Copies of the charts have been placed in the files of the Committee.)

The introductory portion of the review, presented by Mr. Koch, was as follows:

Progress this year has brought us much closer to achieving out national economic goals. Unemployment has declined, while production, personal incomes, and consumption have advanced. The economy, stimulated in part by increased military activity, is operating closer to full potential now than at any other time in nearly a decade. Fortunately, price increases thus far have continued to be selective, and no pervasive upward pressures on prices or costs have developed. Internationally, our payments balance, though far from satisfactory, has taken a turn for the better, as the voluntary foreign credit restraint program has proved effective.

Appropriate policy decisions in an environment like this are especially difficult to make. It might not take much of a move toward ease or restraint of either monetary or fiscal policy to tip the scale toward inflation on the one hand or recession on the other.

Our analysis this morning deals with some of the major issues and problems of economic policy associated with increased use of resources, both nonfinancial and financial. It is selective, counting on the green book[1/] for a more detailed and comprehensive coverage of most recent developments.

1/ A document entitled Current Economic and Financial Conditions prepared by the staff and distributed under date of November 17, 1965; a supplement was distributed under date of November 19. Copies have been placed in the files of the Committee.

Mr. Hersey then presented the following discussion of international developments:

Last February, the President announced a program to "achieve a substantial reduction in our international deficit during 1965, and secure still further improvement in 1966." The 1965 part of this objective is being fulfilled. The deficit on the "liquidity" basis will probably be about $1-1/2 billion, compared with more than $2-1/2 billion in almost every one of the previous 7 years. The deficit on the new "official settlements" basis will probably be only about $1/2 billion, compared with $1-1/4 billion last year and substantially more in earlier years. The 1965 deficit would have been even smaller had the U.K. Treasury not converted about $1/2 billion of its security portfolio into assets we count as liquid.

This year's improvement has occurred despite a decline in the current account surplus. It has resulted from a very sharp reduction in the net outflow of U.S. private capital, from $6-1/2 billion, the average for the two halves of 1964, to an annual rate of about $3-1/2 billion in the first half of this year, and also in the third quarter. Now, what is the prospect for capital outflows in 1966?

This year, a sharp cut in bank credit outflow has been achieved under the voluntary restraint program, reinforced by the interest equalization tax and also by stronger domestic credit demands and more moderate demands from some foreign borrowers. With the restraint program continuing in 1966, outflows of bank credit (that is, loans and acceptance credits) may be held near this year's reduced average--about $150 million per quarter. The substantial reflow of U.S.-owned liquid funds (including banks' liquid claims as well as those of corporations) during the first half of 1965 was a once-for-all phenomenon, and the expected diminution of reflow, already apparent in the third quarter, will represent a sizable element of worsening between 1965 and 1966.

Direct investment outflow expanded very sharply late in 1964 and early this year. It has since diminished, but the year's total will be very large. The voluntary program is being strengthened to hold down such outflows in 1966; but there seems little prospect of a reduction sufficient to offset fully the expected shrinkage in reflows of liquid funds. Finally, outflows into foreign securities seem

likely to remain of moderate size, with the bulk continuing to go to Canada. Canadian issues have been exempted from the interest equalization tax on the understanding that they would not increase Canadian reserves.

In fact, Canadian reserves have risen considerably since that understanding was reached in 1963, and have continued to rise this year, partly owing to large wheat sales to Russia. As a result, U.S. and Canadian authorities have taken action to obtain deferment of further new Canadian security issues in this country until next year.

Changes in credit conditions this year may have begun to reduce incentives to U.S. capital outflow. Credit has tightened somewhat here, and has eased in Japan, Italy, France, and Belgium. But credit demands from Canada and the less developed countries remain strong. The United Kingdom may continue to attract flows from other countries as confidence in sterling recovers further. Interest rates are very high in Germany, and once they stop rising, the prospect of capital gains on German bonds may become attractive.

Thus, balance of payments improvement in 1966 is probably not to be expected from a further net reduction in total outflows of U.S. capital, even with some strengthening of voluntary restraints. It must come mainly from renewed expansion of the current account surplus, with possible assistance from cessation of British sales of U.S. securities

This year the current account surplus diminished to a $6 billion rate in the first half, but picked up in the third quarter to nearly the $7-1/2 billion level first attained last year.

A sharp rise in U.S. merchandise imports contributed to the current acccount deterioration during the first half of 1965. Now, as steel imports subside, total imports may settle back within their past range in relation to GNP. But the general tendency in recent years has been for imports to rise at least as rapidly as GNP.

Exports dropped sharply during the first quarter because of U.S. port strikes, and the shortfall was not made up in the second quarter, partly because of slackening demand in Japan, in some European countries, and in some less developed countries. In the third quarter, exports rose encouragingly, to a level 7 per cent higher than a year earlier. But with imports up 12 per cent over the year, the trade surplus was not yet back to the 1964 highs.

One fundamental change in underlying trends has made achievement of a rising U.S. trade surplus more difficult. In the past two years, economic expansion has become more rapid in the United States than in Europe, where labor force growth has been very small. European import demands have risen faster than output, but have been weakened, until lately, by recession in Italy and slower growth in France. Renewed expansion is now under way in those two countries. However, their rising import demand may be offset by some easing of demand in Britain.

On balance, the trade surplus next year may be near the third-quarter level. This would mean a gain for 1966 over 1965. On other types of current transactions, little net change is anticipated. The gradual reduction of net military expenditures has now ended, and is beginning to be reversed. But further growth of net investment income is likely as a result of continued additions to U.S. direct investments abroad. Thus, it appears that the current account surplus will increase in 1966.

Accordingly, there should be some further improvement in the over-all payments position, if outflows of U.S. capital are held down by the voluntary programs and if U.K. Treasury sales of securities end.

But beyond 1966, it will become increasingly difficult to limit capital outflows by voluntary programs. Since the objective in any case should be to permit greater freedom, continued improvement in the current account will be needed. In this connection it remains of crucial importance to avoid inflationary developments in the U.S. economy, so as to take full advantage of price increases still occurring in most industrial countries abroad despite their anti-inflationary programs.

Mr. Garfield commented as follows on domestic business developments:

With a further substantial rise in GNP in the current quarter, the total increase from the fourth quarter of 1964 to the fourth quarter this year will be about $48 billion. This is considerably larger than the rise over the previous four quarters, but after allowance for last year's auto strikes this year's increase in GNP is similar to last year's. So also is the increase in consumer expenditures. Increases in business fixed investment and in State and local government outlays also are similar, and residential construction has shown little change for more than 2 years.

Inventory accumulation--although large for 1965 as a whole--in the current quarter is down appreciably from the fourth quarter of 1964 because of the shift to liquidation of steel stocks. Federal spending is up substantially from a year ago, mainly as a result of intensified operations in Vietnam.

Continued expansion in business fixed investment and the upturn in Federal outlays have played major roles in maintaining the rate of increase in total output and thus in raising rates of resource utilization. That these categories of spending will continue to expand well into next year has become increasingly evident, and present uncertainties focus on the likely degree of expansion in relation to growth in available resources.

Turning first to the Government's role, the impact of Federal activities in 1965 is not adequately described by the increase in spending for goods and services. Receipts rose sharply in the first half; the resulting shift to surplus in the national income budget and the growing full employment surplus once again provoked discussion of tax reduction to deal with "fiscal drag." In the second half, the cut in excise taxes, increasing expenditures for Vietnam, Government pay increases, and retroactive advances in social security benefits combined to throw the budget back into deficit.

Looking ahead, military spending and social security payments are expected to rise further in the first half of 1966, and additional excise tax cuts take effect. However, increased social security and other tax receipts will more than compensate, and the actual deficit will be reduced.

Clearer assessment of the impact of likely Federal operations must await the January budget announcement, which may have immediate effects on expectations and business decisions. But judgments about the impact of the budget must also depend in part on the strength of private demands.

Business plans to add to plant and equipment remain strong. Although outlays for 1965 as a whole are up 13 per cent from last year and almost 40 per cent from three years ago, the McGraw-Hill survey shows a further rise of 8 per cent for next year. Spending might rise even more; in the past two years realized gains were 8 to 10 percentage points greater than anticipated by the autumn surveys.

Business fixed investment, as shown in the GNP accounts, has been rising at an annual rate of 10 per cent. Over the past year, resources have been available to permit this increase and also the expansion it contributed to in other types of spending without a general rise in prices.

The share of fixed investment in GNP increased somewhat further, almost to the 1956 proportion. Given the large expansion already achieved, the question arises whether investment plans for next year are solidly based on supporting factors. First of all, would continued increases in output at recent rates maintain capacity utilization at recent advanced levels?

Measures of change in capacity are available only for manufacturing, which accounts for a third of GNP and a half of plant and equipment outlays. The McGraw-Hill survey of last spring showed an increase in manufacturing capacity for this year of 6 per cent--a historically high figure but no higher than the rate at which manufacturing output has been increasing since early 1963. Next year's capacity increase, resulting partly from outlays already made, is likely to be greater--perhaps 6-1/2 or 7 per cent. This would not be appreciably in excess of the 6 per cent rate of expansion in output since 1963; but any important slowing of the expansion in output could provoke downward revision of plans for further increasing capacity. Outlays for replacement and modernization, which still account for more than half of the total, are also subject to change with changes in expectations.

If producers do fulfill their plans for increasing plant and equipment outlays, can the machinery industries cope with the resulting demands? Recently shipments of machinery have continued to trail new orders although reported operating rates in the machinery industries are not yet up to 90 per cent.

Capacity in the machinery industries reportedly has increased 5 or 6 per cent this year compared with only 3 per cent in 1964, and sharply rising investment expenditures by these industries suggest that expansion of their capacity is accelerating further. If so, it appears that new orders can rise almost as fast as they have been rising without unduly increasing backlogs. Appreciable upward revision in spending plans, however, would be likely to widen the gap between new orders and shipments, and would foster a climate in which upward pressures on prices and costs tend to mount.

Although rates of resource utilization have increased further this year, business decisions are being made against a background of selective rather than widespread upward pressures on prices. The wholesale index has tended to level off following its increase in the first half of the year. The rapidity of that increase reflected mainly a rise in foodstuffs, as livestock prices increased sharply in response to curtailment in production, but the industrial index was also rising. In the 9 months from September 1964 to June 1965, industrial prices rose at an annual rate of 2 per cent; since June the rise has slowed to a 1 per cent rate.

The selective nature of the rise is illustrated by the dispersion of changes among 70 groups of industrial commodities. A large proportion of commodity groups were practically unchanged--32 per cent in the period from September 1964 to June 1965, and 46 per cent in the period from June to October. In both periods the proportion of groups increasing exceeded the proportion decreasing--by about three to one; but most changes were small.

Nonferrous metals account for much of the rise of 1.7 per cent in the industrial group since September 1964. Releases from the stockpile will help to meet increased military requirements for copper and aluminum. The copper situation threatens to become worse, with new strikes in Chile and uncertainty about supplies from Zambia and Katanga. The recovery in prices of petroleum products also made a large contribution to raising the industrial index.

Most other major materials have shown little if any increase. Textile prices and mill margins are inflated in that fiber prices have declined while product prices have not. Among paper products and chemicals, increases have been scattered. Of 105 industrial chemicals, only 22 have increased from a year ago while 8 have declined and 75 have not changed; the average is up 1 per cent.

Steel products have increased little since 1963, the nonmetallic minerals group has been stable, and lumber and plywood have been dominated by seasonal and other short-run influences.

Altogether, increases in prices of industrial materials have been large in only a few cases, and while wage rates have continued to rise, increases in unit labor costs have been neither widespread nor large. Prices of finished industrial products have not been subjected to pervasive upward pressures of costs, and the rise in the over-all industrial price index has been moderate.

Continuation of this relatively favorable price-cost performance may prove possible, provided business investment and Government outlays do not rise considerably faster than indicated by current plans. Projected increases for these and other outlays, given continued growth in industrial capacity and the labor force, would not appreciably change rates of resource utilization.

Mr. Partee presented the following comments on financial developments:

Financial markets, more than markets for goods and services, have shown evidence of strains on available resources this year. Bank liquidity has been reduced further, and interest rates have risen significantly. An attempt to identify the sources of increased financial market tensions--in particular, to differentiate basic forces of demand and supply from the effects of changing market expectations--should help to provide perspective on the probable course of financial developments in the weeks and months ahead. We turn first to a review of credit demands.

Funds were raised by private domestic nonfinancial borrowers--individuals, businesses, and State and local governments--at an annual rate near $65 billion in each of the first three quarters of 1965. Though declining slightly in the third quarter, private borrowing has remained larger this year than last. Increased private spending has been primarily responsible, but the ratio of private credit expansion to spending also has risen.

Federal borrowing, seasonally adjusted, declined in the second quarter--and also in the third, when the Treasury ran down its cash balance. Foreign borrowing also fell below the first quarter high, as the voluntary credit restraint program curbed bank lending abroad.

As a result, total credit flows fell to a seasonally adjusted low in the third quarter. But this was, in large part, a consequence of Treasury debt operations that are now crowding a large volume of cash financing into the final three months.

On the demand side of credit markets, pressures on available funds have come mainly from unusually large business borrowing, especially from banks. The annual

growth rate of business loans has remained well above that of earlier years, though declining from quarter to quarter. Further tapering occurred after the steel settlement, but figures for recent weeks suggest some resurgence in loan demand.

In contrast with business borrowing from banks, corporate security issues have risen over the course of the year, and the calendar for the weeks ahead is heavy. This reflects primarily the continuing expansion in plant and equipment spending, but may also be related to reductions in corporate liquidity. In the fourth quarter of last year, seasonal increases in corporate liquidity ratios were smaller than usual, and reductions so far this year have been substantially larger than the trend of the past several years.

Consumer borrowing also has been relatively large this year. Increases in total consumer credit have been at annual rates of about $9 billion in each of the past three quarters, compared with a $7 billion increase in 1964.

Municipal security issues, on the other hand, have been only moderately larger than in the past two years. Mortgage debt has continued to expand at about last year's $26 billion pace.

The unusually rapid growth of business loans at banks has been broadly distributed by industry. The effects of the steel inventory buildup are clearly evident in the borrowings of metals and metals-using firms at weekly reporting member banks. Borrowings of public utilities and trade firms also have been large. In fact, growth in bank loans to business exceeded year-earlier figures in all major industrial categories, reflecting the general strength of business investment as the economy moved toward higher resource utilization.

Growth in business fixed investment and inventory accumulation since the third quarter of 1964 has been considerably larger than the expansion in gross retained earnings, and has been the principal factor increasing business external financing. Capital spending abroad also has risen. Additionally, the distribution among industries of the growth in retained earnings has not matched that of investment. Retained earnings in manufacturing, for example, were up sharply in the first quarter, but declined in the second quarter and possibly also in the third. In contrast, manufacturers' outlays

for fixed investment and inventories have continued to rise rapidly.

The resulting increase in business credit demands, which focused heavily on the banking system, encouraged banks to bid more aggressively for funds, and rates on CD's and Federal funds continued the rise that had begun late in 1964. Monetary policy, meanwhile, pursued a course that required a larger portion of the increase in bank reserves during the first half to come through the discount window. Member bank borrowings rose to a peak in August, and have declined only slightly since then. Movements in free reserves have mirrored the pattern in borrowing this year, since excess reserves have changed little.

Reduced reserve availability during the second quarter was accompanied by a moderately slower growth rate of total bank reserves than had prevailed earlier in the year. Then, in the third quarter, total bank reserves declined--as Treasury deposits fell sharply--and reserve growth did not resume until October.

The third quarter contraction in Treasury deposits was not fully offset by more rapid growth of private deposits, so that expansion in total bank deposits slowed. Growth of the money stock did accelerate in the third quarter, however, and by the end of October the annual growth rate for the year to date had risen to 4.4 per cent, about equal to the 1964 rate. Time deposit growth also increased in the third quarter, partly as the result of the success of banks in marketing savings certificates and bonds.

The unusual pattern of Treasury financing this year has made changes in bank credit difficult to interpret. A measure that circumvents some of the difficulties is the growth of bank credit exclusive of changes in bank holdings of Treasury securities and bank loans to brokers and dealers secured by Governments. This can be viewed as a measure--though imperfect--of the banking system's contribution to the financing of private spending.

Net new funds supplied to private borrowers by banks declined in the third quarter, and the decline exceeded that in total private borrowing. Funds supplied by other savings institutions showed little increase, as these institutions continued to feel the pressure of competition for savings flows from commercial banks. The private nonfinancial sectors,

as a result, had to supply a larger quantity of funds directly to the private credit markets in the third quarter than in other recent years. Higher interest rates were required to encourage them to enlarge their purchases.

This increase in funds supplied by individuals and businesses was accompanied by growing expectations that private credit demands might rise further, in line with continued vigorous expansion in economic activity. It was recognized, also, that the Treasury would soon be returning to the market in volume. The swing in market expectations reinforced the more basic forces of demand and supply, and also exerted upward pressure on interest rates. The rise in market rates of interest in evidence prior to midyear in the corporate and municipal bond markets became more general as rates on Treasury issues joined in the advance during August. Rate increases since early summer have been both rapid and substantial; yields on long-term corporate and Treasury issues are close to the peaks of early 1960. Rates on municipals and on Treasury bills also have increased since midyear, but are still below their earlier peaks.

The concluding part of the staff presentation was given by Mr. Brill, who reviewed more recent developments in financial markets and then summarized the analysis and its implications for policy, as follows:

Interest rate pressures developing during the third quarter continued in evidence in October and early November, as market conditions reflected heavy Federal borrowing and uncertainties about military spending, the potential strength of private credit demands, and the course of monetary policy. Most recently, markets for Treasury securities have quieted somewhat and rates have shown some signs of leveling. Nonetheless, conditions in financial markets remain taut and market sentiment uneasy, with peak seasonal pressures just ahead.

Are existing financial conditions appropriate, in the light of developments in the real sectors of the economy and in the balance of payments? Thus far, price changes in commodity markets have continued to be

selective and, for the most part, moderate. Since June, increases in the industrial average have been smaller than earlier. The Administration's efforts to contain wage rate advances in key industries, and to hold the line on prices of basic industrial materials, have no doubt contributed to this stability.

But availability of resources to meet expanding demands has been a more fundamental factor in containing price pressures. Next year's additions to plant capacity are likely to be even larger than this year's, and additions to the labor force are also expected to be larger. At the same time, resources of efficient plants and trained workers are not unlimited, and new price pressures could develop if military activities increase substantially or investment spending rises much faster than is now indicated.

In our international payments accounts next year, moderate further improvement seems likely, in view of the probable increase in the current account surplus and the additional measures planned by the Department of Commerce to hold down direct investments abroad. Such progress will depend importantly on maintenance of our favorable cost/price record, as well as the continued cooperation of the financial community and increased cooperation of nonfinancial corporations in restraining capital flows.

If an assessment of economic pressures and of other Government policies should lead to the conclusion that the present stance of monetary policy is appropriate, what would this mean operationally, in terms of reserve targets and money market relationships? Any answer must be approximate and tentative, given the precarious equilibrium in financial markets. As best we can estimate, holding net borrowed reserves in the $100-$150 million range until mid-December would be likely to be accompanied by some further upward creep in bill rates, but perhaps with only minor implications for long-term rates so long as market expectations do not change.

However, quoted CD rates are generally at their ceilings, and further narrowing of the spread between market rates and CD ceilings would make it difficult for banks to replace the large CD maturities expected around mid-December tax and dividend dates. If credit demands on banks continue heavy, market pressures could intensify in the final weeks of the year. Indeed, to hold close to current rate relationships at that time may require

both increased provisions of nonborrowed reserves and some increased flexibility for banks to compete for funds.

If an assessment of the situation suggests the need for increasing monetary restraint now, the flow of nonborrowed reserves could be limited. The impact on market rates of a deeper net borrowed reserve position would likely be substantial and relatively prompt. The rise in rates could be expected to pervade all maturities. Expectations of a discount rate increase would reinforce and perhaps make cumulative the upward pressure on market rates, and the CD market would require immediate relief if contraction in bank deposits were to be avoided.

My own assessment weighs out in favor of the first course of action. Given the knowns and the uncertainties in the economic scene, domestic and international, the case seems persuasive to me that present taut conditions in financial markets are providing all the monetary restraint needed at the moment, and the possibilities are that these conditions will become even tauter before year-end.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy. Mr. Hayes, who spoke first, made the following statement:

The set of economic conditions on which our policy must be based is largely unchanged since three weeks ago. Such minor changes as have occurred in the over-all economic picture have tended to confirm even greater strength in the domestic economy than at the time of our last meeting and an even less satisfactory balance of payments situation than was apparent at that time. Finally, it is becoming ever clearer than artificial rigidities in the interest rate structure are handicapping the efficient flow of funds in the economy. In my judgment the time has come for monetary policy to make a significant further contribution to more balanced and sustainable growth in the domestic economy and a strengthening of the dollar's international standing.

I recognize that the Treasury is in the process of completing its November financing schedule, but I believe that we are at last able to reach policy

decisions without the constraint of even keel considerations. The November refunding is pretty much out of the way, and while distribution of the tax anticipation bills, for which payment is due tomorrow, is not completed, this is not enough to be a major deterrent to action on our part. I might point out also that with additional Treasury financing probably due to be announced sometime between mid and late December, the period in which we are free to act will not last very long.

With respect to the domestic economy, the longer-term outlook remains strong, and business optimism seems more firmly based than a few weeks ago. The prospective buoyancy of plant and equipment spending is especially impressive. Incidentally, I can see no ground for fear that the recent disparity between rates of output growth for capital and consumer goods has meant a tendency toward overbuilding of capacity. On the contrary, plant utilization rates have risen very appreciably since 1961, despite large additions to capacity, and seem to have remained about unchanged in 1965. With the likelihood that GNP will be growing at a rate of around $11-12 billion per quarter in 1966, the gap between actual and potential levels of activity will probably narrow further; and this should mean continued pressure on industrial capacity and on the labor market. The over-all unemployment rate over the year ahead is, at worst, likely to be no higher than the October 1965 figure of 4.3 per cent and may well decline below 4 per cent. If so, increased shortages of skilled and even other workers will probably develop, and wage rates may be subject to excessive upward pressure. Economic prospects also seem conducive to price increases, despite the prospect of further productivity gains and the Administration's recent strong stand in opposing price increases by means of the guideposts and moral suasion. There is always a risk too that the course of events in Vietnam might intensify the stimulus provided by rising Federal outlays.

Our international problem remains decidedly serious, with balance of payments statistics continuing to make disappointing reading. The October deficit is estimated around $300 million and our November weekly indicators still register deficits of varying magnitudes. Prospects are that the regular deficit for 1965 will exceed $1.8 billion and may possibly be as high as $2 billion.

Changes in the method of reporting the deficit cannot conceal the fact that our accounts are still badly out of balance, even after allowing for the fact that liquification of British security holdings tended to amplify the deficit. Moreover, the "official settlements" balance for recent quarters is almost meaningless in the light of the very large foreign exchange operations of the Bank of Italy, carried out with the cooperation of the U.S. authorities. The weakness of our payments position is especially worrisome at a time when we are commencing difficult negotiations on the future of international financial arrangements.

Turning to credit developments, we find that bank credit showed renewed and pervasive strength in October after a weak September. In the first ten months of 1965 bank credit was growing at the rate of 9.7 per cent per annum, well ahead of the 1964 rate. While there has been some slackening in business loan growth since mid-year, as corporations were able to tap other sources more effectively, there has been renewed strength in early November, and most banks look for continuing strong general loan demand. Money supply and time deposits grew in the first ten months at an annual rate of 9.6 per cent, as compared with 7.9 per cent for all of 1964. An examination of broader indicators of credit growth reveals that while banks accounted for a larger share of the total than in 1964, there was also a substantial rise in the rate of total credit growth. Reduced corporate liquidity, combined with the prospect of heavy business spending, points to the likelihood of further heavy demand for credit from all available sources.

A final factor of great importance is, as I mentioned at the last meeting, the distortions in the interest rate structure resulting from a combination of heavy credit demands throughout the maturity range and rate rigidities introduced by regulatory or statutory ceilings and political pressures. For example, now that the leading city banks are paying the ceiling rate on 3-month certificates of deposit, any further upward movement of market interest rates could bring a severe loss of bank deposits and a consequent shrinkage of bank assets. The prime rate, which has become a favorite subject for political attention, is out of line with rising rates in the corporate bond market and with the rising cost of

money to the banks. The 4-1/4 per cent ceiling on the coupon rate applicable to new Treasury bond issues is now proving to be a major obstacle to the continued flow of savings into the Treasury. And finally, the discount rate is becoming more and more out of line with market rates of interest.

In my judgment this combination of circumstances points to a clear policy conclusion. The time has come for an overt move to signal a firmer monetary policy, and an increase in the discount rate by 1/2 per cent is the appropriate means of effecting such a change. It seems to me imperative that the System take this action to lend additional support to the voluntary foreign credit restraint program. That program may well prove increasingly difficult to administer in the absence of such additional support, and in any case it is not too early to be striving for a more basic improvement in our payments position. Not only is the economy amply strong to withstand any effects of firmer interest rates, but we are probably very close to the point where continued sustainable domestic expansion depends on greater effort to keep inflationary pressures under control--and of course this is of vital importance in connection with the maintenance of a large external trade surplus. In view of these considerations, it seems no more than prudent to try once again to slow the recent excessive rate of bank credit expansion. Finally, a discount rate increase, with an accompanying increase in Regulation Q ceilings, would permit greater reliance on market forces and interest rates in channeling the flow of funds.

Most of the directors of the New York Bank have felt for some time that an increase in the discount rate is overdue. Indeed, on a number of occasions some of them have urged that the Bank take the initiative in this area. I am now prepared to recommend that they vote a 1/2 per cent discount rate increase within the next week or so.

As for open market operations, it seems to me that we would be well advised to avoid any significant change until we have had time to observe the effects on the market of a discount rate rise. An overt change in System policy before the end of the year is apt to come as something of a shock to the market. While the technical position of the market is much better than a

month or so ago, we have to be prepared for a rather strong initial reaction to a discount rate change. No doubt market interest rates will move higher, and I believe it would be wise, for the time being at least, to keep reserve availability about unchanged while meeting the seasonal reserve needs expected in the weeks ahead. I think the Manager should be allowed fairly wide discretion to keep the market adjustment as orderly as possible, and we should be prepared to tolerate some increase in net reserve availability if this turns out to be necessary. For the moment I should think we might instruct the Manager to maintain about the same money market conditions as have prevailed in the past three weeks. Accordingly, draft directive A, as proposed by the staff, seems quite satisfactory, except that I would add the words "reflecting strong credit demand" after the words "firmer financial conditions."1/

Mr. Ellis reported that the Boston Bank's regular business outlook conference last week confirmed, as expected, the standard forecast of continuing GNP growth at about $10 billion per quarter through next June. Among the varied reports, two items drew his attention as evidence of the narrowed margin of unemployed resources: an aircraft corporation was attempting to expand its Hartford work-force by 1,000 persons per week for 8 weeks; another Connecticut employer was offering a $50 "finder's fee" to present employees for each new worker hired as a result of their personal recruiting efforts. Another conference participant indicated that insurance company current commitments were running at 93 per cent of cash

1/ The two alternative directives suggested by the staff are appended to these minutes as Attachment A.

flow--a record high for the industry. In anticipation of further needs for funds, a larger number of companies had established lines of credit at commercial banks, a number of which had not been used as yet.

In Mr. Ellis' judgment, it would be difficult to fault the economy and its progress when appraising it in real terms. Real growth was substantial, but not so rapid or distorted as to have caused production bottlenecks. Expansion and modernization was being concentrated where capacity was tightest. Unemployment had been and continued to be reduced. The outlook was universally conceded to be for further such growth, with no widespread convictions that rapid price inflation was inevitable. Economic strength seemed firmly based, not weakly balanced.

When described in financial terms, however, the current picture was less reassuring. It was difficult to feel secure when the money supply was expanding at 7.6 per cent (on a three-month average) while GNP was expanding 4.7 per cent in real terms. Even given the substantial expansion of intermediation by commercial banks, it was disturbing to contemplate a 20 per cent year-to-year increase in business loans, against a 9 per cent parallel gain in industrial production.

Without being able to measure the degree, Mr. Ellis said, it was nevertheless apparent to him that the quality of credit

extended had declined. Without being able to assess its full potential, it was evident that banks had greatly reduced their liquidity and their capacity to withstand financial shock. While the balance of payments had improved over the past year, it was evident that further measures would be required to restrain capital outflows. One such measure, a move toward lesser ease would not only buttress the special credit restraint measures being employed but would serve as a widely understood monetary signal that would strengthen the willingness to hold dollars abroad.

Mr. Ellis said he used the phrase "lesser ease" because in retrospect the record suggested that the Federal Reserve had eased its reserve availability and allowed an accelerated expansion of reserves while limiting rate increases. Member bank borrowings averaged in excess of $525 million each month between June and September. In October they averaged $490 million, and they averaged $438 million for three weeks of November. After declining in August and September, nonborrowed reserves expanded at a 5.5 per cent annual rate in October and at about a 6 per cent rate in three weeks of November. Meanwhile, 3-month bill rates, which rose 8 basis points in September and 10 basis points in October, had been held to a 5-point rise in November. Concern that higher bill rates would force a discount rate increase had tended to

translate a "voluntary" prime rate ceiling of 4-1/2 per cent into a 3-month bill rate ceiling of 4.10 per cent.

Looking ahead, however, the Committee must contend with the historical fact that in years of strong credit demands bill rates normally rose 8 or 10 basis points in response to seasonal pressures alone in the next several weeks. In Mr. Ellis' judgment, the Committee should not pour out reserves in an effort to enforce a rate ceiling against seasonal pressures. While it could quite properly seek to insure that rate movements did not become disorderly, it should not seek to enforce a ceiling at any level. The result would be to destroy the market's ability to set its own rates and the Committee's ability to judge true demand and supply relationships in the market. Interest rates were too important to be left to arbitrary judgments from any source.

At the meeting yesterday of the Boston Bank's directors, Mr. Ellis said, he took the position that this was not the proper moment to raise the discount rate. Member bank borrowings were running lower than for any month since March. Bill rates had been stabilized in recent weeks. Business loan demand was just about meeting seasonal expectations.

Mr. Ellis said that although he agreed with Mr. Hayes' analysis, he would reverse the sequence of moves. He would move on reserves first and the discount rate later. His choice would

be to restore reserve objectives to primary positions as targets of policy. Now that the Treasury financing schedule had been completed for the year, it should prove feasible to establish a goal of moderate reserve growth associated with net borrowed reserves averaging $150 million. If demands for credit exceeded seasonal patterns, the Committee should expect borrowing to exceed $550 million and some tendency for short bill rates to rise to 4.20 per cent or higher. The underlying philosophy of such an approach was to throw onto the market the responsibility for revealing the degree of pressure for credit expansion. If higher rates, including higher discount rates, were to eventuate, they should result from increased credit demands against a steadily growing reserve base.

Mr. Ellis said he was attracted to alternative B of the draft directives. However, what he had suggested in terms of policy could probably be carried out equally well under alternative A.

Mr. Irons reported that the latest estimates in regard to Eleventh District economic activity continued to reflect expansion and growth, particularly in the major areas of activity. There had been an increase in manufacturing output, both of durables and nondurables. The petroleum situation showed improvement, as did the chemical situation. Construction continued strong.

Employment continued to set new records, with increases in both the manufacturing and nonmanufacturing sectors. The unemployment rate stood at 3.2 per cent. Automobile sales were exceptionally good, and the agricultural situation was very strong this year as compared with preceding years.

Bankers reported that the pressure for loans continued unabated, although the loan figures showed relatively little change from the high levels that had prevailed. In fact, the banks had reduced their loans a bit in the recent period, while disposing of some Governments and increasing their holdings of other securities. Although they were not borrowing from the Reserve Bank heavily, they were active in the Federal funds market, with substantial net purchases. The discount window had about cleared out the seasonal type of agricultural lending. Those banks that were now out of debt to the Reserve Bank might find it easier or preferable to go into the Federal funds market and come to the Reserve Bank only when funds were not otherwise available.

The general attitude in the District was optimistic, Mr. Irons said, although there was some degree of concern about the inflationary potential. On the national side, he agreed with the data in the green book and the supplement to it. His appraisal of the material was that it confirmed the strength of the economy, with continuing expansion on a broad basis. He anticipated a

substantial rise in final demand through the fourth quarter and on into next year. Most economic indexes seemed likely to rise further. Demand was beginning to press on capacity, and cost pressures seemed likely to increase as labor markets continued to tighten.

Money and credit markets reflected firmness, with demands placing pressure on the supply of available credit. Apparently there was some uncertainty in the market as to the probable cost and availability of credit, and perhaps as to the position the Federal Reserve would take on credit availability. This raised the question whether a more positive position would be desirable. This was the time of the year when seasonal pressures were present, and in addition other influences had entered into the picture with regard to rate levels and rate administration.

Mr. Irons said his thinking was somewhat along the lines of that expressed by Mr. Hayes. It seemed to him that there might be some advantage in a confirmation of recent rate movements in the market through a discount rate change. Such a move would dispel some uncertainties. But he was not sure it would be necessary to raise the discount rate to 4-1/2 per cent. The present market rate structure was roughly compatible with a 4-1/4 per cent discount rate, so a change in the rate to that level would be a confirmation of the market rate structure and an indication of the System's policy thinking. Such a move might in

the long run be more effective than either deferring a discount rate change or taking a stronger action at this particular time. This brought in the whole question of timing, considering the atmosphere in which the Committee found itself and the framework within which it operated. He was not certain about those factors, and he realized there were counterarguments to a course of action such as he was suggesting. Nevertheless, it might tend to quiet uncertainties, confirm a position the market had taken, and perhaps lessen the possibility of further substantial rate increases.

Mr. Irons thought in terms of directive alternative B, but he did not have strong feelings one way or the other. Either A or B of the draft alternatives would seem compatible with a policy approach such as he had outlined.

Mr. Swan reported that employment in the Pacific Coast States increased somewhat in October in all sectors except construction and mining. But with the labor force growing the unemployment rate remained unchanged at 5.6 per cent. Employment in defense-related manufacturing had improved slightly further. Construction contract awards increased in September--the latest month for which statistics were available--and for the first time the cumulative figure for the year to date was above that of the comparable period in 1964. But the increase was only 1-1/2 per

cent, compared with an increase of 4 per cent for the country as a whole.

In the three weeks through November 10, total credit of Twelfth District weekly reporting banks declined as the loan increase was more than offset by a decrease in securities holdings. However, the rise in commercial and industrial loans was considerably greater than at weekly reporting banks throughout the country, representing a reversal for that period of the earlier relationship. Even so, the reserve position of the Twelfth District banks in recent weeks had been relatively easy, and their borrowings from the Reserve Bank had been extremely low.

In terms of the national picture, Mr. Swan was inclined to agree with the analysis in the green book. The situation was not appreciably different than at the time of the last meeting of the Committee, but it certainly remained a strong one.

In terms of policy, Mr. Swan said, the situation was quite difficult, but it seemed to him the Committee ought to maintain its current posture. He recognized that the need for overt action might be somewhat closer. Like Mr. Ellis, however, he was inclined to think that the point had not yet been reached. He noted the relationships discussed in the blue book[1/] as between net borrowed

[1/]A document entitled Money Market and Reserve Relationships prepared by the staff and distributed under date of November 19, 1965. A copy has been placed in the files of the Committee.

reserves and interest rates and the prospective basic provision of nonborrowed reserves, seasonally adjusted, at about a 2-1/2 per cent annual rate for November. If those relationships continued, the Committee could live with the situation. However, he agreed with Mr. Ellis that emphasis should be placed on the provision of reserves to take care of seasonal needs. If credit demands should turn out to be considerably stronger than seasonal, so that there was some reflection of those pressures in market rates, the Committee would be faced with the question of what action to take. But the situation should be allowed to develop first. He would stay for the moment with net borrowed reserves of $100-$150 million rather than to raise the sights slightly in those terms. Consequently, he would accept alternative A of the draft directives.

Mr. Galusha said all indications were that economic activity in the Ninth District was continuing to expand at a satisfactory rate. Only about the construction industry could there be pessimism. With the dollar value of contract awards down sharply from a year ago, the industry's immediate future was not exactly bright with promise. Otherwise, however, current economic intelligence was decidedly encouraging. Although the dollar figures showed a significant expansion, the ratio of classified loans was more favorable than for the preceding two years. No major price shifts had come to his attention except in the area of packaging materials.

As for the national economy, a bearish cast could be put on some recent economic news. For instance, it could be argued that next year's revision of the November 1965 McGraw-Hill plant and equipment spending forecast would not be anything like the revisions of 1964 and 1965--the reason being that this November's accompanying sales forecast seemed so much more reasonable than those made in November 1963 and, even more, in November 1964. And it could be argued--on the basis of recent auto sales--that the industry would not do quite as well in 1966 as it did in 1965. Yet the fact remained that it was difficult to make the outlook for 1966 anything but bullish. That apparently was the most prudent assumption upon which to base current decisions about monetary policy.

The issue, therefore, was whether coming quarters would not find business a shade too good. In that connection, the information about the behavior of money wages and industrial prices contained in the green book was encouraging. So was the staff's judgment that a fourth quarter increase in GNP of $10 to $12 billion would not change the average utilization rate or, presumably, bring on an acceleration of the moderate price creep that had been experienced.

Mr. Galusha observed that evidently no one was expecting an average quarter-to-quarter increase in GNP for 1966 of more

than $12 billion. The most optimistic forecasts, which by the way probably did not take full account of the most recent increases in long-term interest rates, implied something rather less than this average increase. Thus, however justified the recent increases in interest rates were, and however justified the recent unwinding of "operation twist" was, further increases in rates might be unwarranted unless the stand was taken that an increase in prices, even if extremely modest and not at all likely to accelerate, should not be permitted.

Nor, Mr. Galusha continued, could an increase in the discount rate be accepted as merely a technical adjustment. There was no basis, whether in theory or experience, for thinking that such an increase would leave open market rates unaffected. If there were circumstances in which that could happen, they were not those of today. The thought that an increase in the discount rate would not bring on an increase in bank loan rates--the prime rate included--was hardly credible. Such an increase might be desirable, but if so the bankers ought to be able to bring it off without help from a "price leader."

Finally, Mr. Galusha said, recent developments suggested that financial markets now believed current rates to be maintainable, so an increase in the discount rate no longer appeared "necessary," if it ever did.

He would be less than candid, Mr. Galusha commented, if the impression was conveyed by his comments that he was not uneasy. His hunch was that the Committee was approaching a moment of truth. Hunches were an important part of professional decision making, but not until experience justified some credibility. Without that experience he must rely on such evidence as came to hand, and the evidence did not appear to warrant a significant change in policy. Of the expressions he had heard thus far, he was inclined toward those of Messrs. Ellis and Swan that within the range of the present directive the Committee could probably exercise adequate restraint, at least for the ensuing period. This would mean that any unusual demand, over and above that which could be predicted on a seasonal basis, should be dampened.

Mr. Scanlon reported that the economic atmosphere in the Seventh District could be characterized as ebullient. Activity was at a high level and was expected to rise further. There were frequent reports of bids on new commercial, industrial, and public construction projects coming in far higher than anticipated and, in some cases, of a reluctance of contractors to negotiate firm prices. Structural steel fabricators were said to be overbooked.

Perhaps the most significant development of recent weeks concerned a further tightening of labor markets despite the reduction in steel output. In September estimated unemployment

rates in District States ranged from 1.3 per cent in Iowa to 2.6 per cent in Illinois and Michigan, compared with 3.8 per cent (unadjusted) for the United States. Insured unemployment rates in the District at the beginning of November ranged from 0.7 per cent in Iowa to 1.2 per cent in Illinois, compared with 2.1 per cent for the United States. For Indiana, the District's largest steel-producing State, the rate was 1.1 per cent, compared to about 1.5 per cent a year ago. Employers were making vigorous attempts to recruit workers, and reports of labor pirating were heard frequently.

Steel production in the Seventh District had been about level since the middle of October. It was believed that the next turn would be upward, although the uptrend would not be appreciable until after the turn of the year. Some selective steel price increases had occurred, principally affecting specialty items and smaller quantities sold through warehouses.

The financial indicators confirmed the buoyant business conditions, Mr. Scanlon said. Although the growth of business loans at Seventh District banks had slowed somewhat in recent weeks, due primarily to repayments by durable goods manufacturers, the increase for the year to date remained well above all recent experience and slightly greater than the record increase for the country as a whole. After adjusting for the temporary intake of

the new tax anticipation bills in October, District banks had continued to liquidate Treasury securities and gave evidence of becoming less aggressive in purchasing other securities. They continued to make less use of the discount window than in past periods of similar rate relationships. In the absence of a change in Regulation Q, reserve pressures on the banks might be expected to increase, culminating on the December corporate tax date when a large volume of CD's was scheduled to run off.

As to policy, Mr. Scanlon said that, like Mr. Ellis, he would not want to resist a modest seasonal rise in rates by invoking a rigid rate objective in the coming period. He would defer any change in the discount rate, although he believed there was considerable merit in Mr. Irons' suggestion. For the immediate future, he favored a policy that would imply slower growth in money and credit and, assuming continued strengthening of credit demand, modestly higher interest rates.

If market forces pressed in that direction, he would expect that in view of seasonal pressures the 3-month bill rate would rise somewhat further, perhaps as high as 4.15 or 4.20 per cent. He would hope that it might be possible to ride with such a policy during the remainder of 1965 and through the early weeks of 1966 while observing economic developments and getting a better line on Federal budget prospects. He continued to feel that any consideration of an increase in the discount rate must be accompanied by

consideration of an increase in the rates banks were permitted to pay on time deposits. While he could accept alternative B of the draft directives, he believed that a policy such as he favored could be carried out under alternative A.

Mr. Clay commented that the national economy continued to expand faster than anticipated earlier and its prospective performance also appeared to exceed earlier expectations. There was little evidence to suggest any lessening of economic activity in the months ahead; rather it appeared to be a question of the degree of advancement. Except for residential construction, activity in all major sectors of the economy was increasing. The scale of prospective Government spending, notably defense outlays, remained of unknown proportions, but military developments strongly suggested that that factor would be expansive beyond present indications.

The remarkable growth in the economy that had taken place had been accomplished in essentially an orderly fashion in terms of resource utilization and prices, as manpower and other resources generally had been available and prices had not experienced a marked breakthrough. With the margin of unutilized manpower and other resources smaller than earlier, however, prices were more sensitive than heretofore. Resource utilization could be expected to continue to grow and, despite expanding resources, the margin of unutilized resources probably would narrow still further in the months ahead.

As the shape of those forces would have to await further developments, Mr. Clay felt that monetary policy could justifiably continue essentially unchanged for the present in terms of money market conditions and reserve availability on a seasonally adjusted basis. Looking further ahead, there was ample reason to wonder whether money and capital market developments might not make the present discount rate and the current degree of reserve availability incompatible. In that event the Committee would need to choose between higher money market rates with current reserve availability, the present level of money market rates with increased reserve availability, or some other combination of those alternatives.

Mr. Clay thought the decision would have to be made on the basis of the economic situation then existing, so as to facilitate potential economic growth within an orderly framework. It was likely that the appropriate course of action would depend on the impact of Government defense spending on the economy. Defense spending had been a significant force in the economy for several months. Should the scale of that program be materially increased, the economy's balanced economic growth might be seriously disturbed.

Alternative A of the draft directives appeared to Mr. Clay satisfactory at this time, and he did not think that a change should be made in the discount rate.

Mr. Wayne reported that Fifth District business continued to improve and showed evidence of acceleration in some sectors. Not a single respondent in the Richmond Bank's latest survey expected business to decline in the near future. Manufacturers in the survey reported increases in orders and shipments, and about one-third reported higher wages and prices. The textile industry had experienced a resurgence of new orders following passage of the farm bill. Labor markets appeared to be tightening across the board. Shortages had become especially acute in the coal industry, causing some recent cutbacks in scheduled deliveries to utilities, and one coal producer reported that some contracts for spring deliveries included price increases of 15 to 25 cents per ton.

Meanwhile, the national economy continued to show moderate gains from high levels of activity. Substantially all of the changes in October were favorable, indicating that the effects of lower steel production were more than offset by strength in other sectors of the economy. Additional reports of labor scarcity and the rise of overtime in manufacturing in October indicated that the pressure on manpower was rising. The production of business equipment continued to follow a spectacular course and to pull farther and farther ahead of the production of consumer goods. Since December of last year the production of equipment had risen nearly five times as fast as the production of consumer goods.

With the prospect of high and rising outlays on equipment next year, it would seem that there was a real possibility of a serious imbalance between productive capacity and the output of consumer goods.

In the international area, Mr. Wayne continued, the threat to sterling now appeared less acute than at any time in recent months. Some of the recent improvement had come, however, at a cost to the U.S. balance of payments. Estimates of the deficit since July were especially discouraging in view of the fact that the deficit was experienced despite the voluntary credit restraint program and the interest equalization tax.

There were some indications that the seasonal demand for credit for the remainder of the year might not be as great as expected earlier. If this was correct, the Committee might be able to get by for the rest of the year without further measures of restraint. In Mr. Wayne's judgment, that was greatly to be desired if it was feasible, since any substantial firming would require action on the discount rate and bring additional pressure for an increase in Regulation Q ceilings. He did not think that the System should resort at this time to an overt action, such as an increase of 1/2 per cent in the discount rate, designed to produce a sharp impact on expectations.

Mr. Wayne felt the Committee had limited room for maneuver. It would not appear that the Committee could seriously consider any easing of credit. On the other side, any substantial tightening would intensify several very thorny problems. Discounting would increase and many banks might face a shortage of Governments to use as collateral. The market would anticipate an increase in the discount rate and general increases in prevailing rates would make it difficult to avoid such a move. The most immediate effect of higher market rates would be to endanger the CD position of money market banks and probably precipitate a drop in the long-term markets. The raising of Regulation Q ceilings would not be an adequate solution to the problem since such a move in itself would promote bearish expectations. In brief, any significant move toward firmer credit would carry a strong implication that the discount rate would be raised soon, and he was not ready to take that step yet. His preference would be to continue present policy, and he found draft alternative A acceptable as a directive.

Mr. Robertson made the following statement:

> The last three weeks have provided us with more confirming evidence that we should go no further in tightening monetary policy at this juncture.
>
> On the price front, the gradual upcreep in the general industrial commodity index has slowed down, and certainly the latest aluminum and copper price rollbacks--whatever their broader social implications--will give a little more pause to any other administered price increases that might have been in the offing.

In financial markets, conditions also seem a little better balanced. Perhaps the most constructive thing that has happened is that market expectations of an imminent discount rate increase have been quieted somewhat. In this calmer atmosphere, funds seem to be flowing fairly well through both the money and bond markets. I see no evidence of any "knots" that need untying by official action.

In the next few weeks the seasonal pressures in the money market will mount to their usual annual peak. If feasible, I would like to avoid allowing such technical pressures to force us into a basic change of monetary policy that might more appropriately wait until the impact of next year's Federal budget can be judged. Some bankers have been insisting that something must be done to resolve interest rate and Regulation Q ceiling questions before the December squeeze, but I think the availability of the Federal Reserve discount window and the Board's capability of revising pertinent Regulation Q provisions quickly, if necessary, combine to give any well-run bank all the safety valves it ought to need for this period. This particular CD squeeze does not seem to me to be the kind of development that should be dealt with by general monetary policy. That, I maintain, should be addressed to the broad performance of the economy, which I regard as too strong to warrant any easing, but not yet so clearly inflationary as to call for further tightening.

Our directions to the Manager, therefore, should be to walk a tightrope between now and year end, keeping money market rates as a group from either rising or falling significantly, and letting net borrowed reserves move where necessary in order to preserve such a money market tone. I would vote in favor of alternative A of the draft directives submitted by the staff, and would hope the Manager would interpret it in the same way as he interpreted the similar directive over the three weeks just past. My views on the discount rate are already known to the Committee from my comments at the last meeting, and I have had no reason to change them.

Mr. Shepardson commented that every available indication pointed toward a strengthening economy. Not only were people talking about good business the rest of this year and in 1966 but

some recent statements projected a continuing rise in 1967. He thought there was clear evidence of increasing over-expectations, and that the rate of money growth and credit expansion was clearly beyond sustainable levels. The Committee had spoken for some time in its directives about a moderate growth, but it did not seem to him that the present rate of expansion could be defined as moderate.

There was concern about what the Federal budget would be, Mr. Shepardson noted. He had no knowledge of what it would be, except that programs already inaugurated were inevitably going to call for more spending. As far as military expenditures were concerned, it seemed inconceivable that with the type of conflict the country was going into those expenditures would not pick up significantly.

The reports around the table, Mr. Shepardson pointed out, all indicated an increasing shortage of labor, and that was bound to bring pressure. Notwithstanding the position being taken by the Administration on certain selected prices, the general pressure of demand on prices would be inevitable. He found it difficult to accept the approach of waiting until the horse was out of the barn before locking the door. Once prices went up, they could hardly be gotten back down. Higher prices would not improve the balance of payments situation, nor would they improve the prospect of long-run economic growth.

It seemed to Mr. Shepardson that all indicators showed sufficient strength in the economy to withstand some restraint. The Committee had been putting off such action until everyone could point to clear evidence in the figures as to what had happened. Personally, he thought it was time to let up on the gas pedal and put on the brakes; in other words, it was time to be moving toward a little more restraint. He was aware of the seasonal demands and would want to meet them, but he would meet them reluctantly, with the result that there might be some increase in negative free reserves to between $150-$200 million. If seasonal demands were as strong as appeared likely, this probably would result in some further pressure on the discount rate, and he would expect a move on the discount rate to be called for in the near future. When it came to the change in the rate, he did not think an increase of 1/4 per cent would settle the matter. If the System was going to move, it might just as well move the rate up 1/2 per cent and give itself leeway to operate for some time into the future.

Mr. Shepardson favored alternative B of the draft directives. He believed that the Committee should try to check the pace of monetary expansion a little if it meant what it said about promoting sustainable growth. He also felt that the System should be prepared for a discount rate increase in the near future.

Mr. Mitchell said the economy was performing better than he had expected it would at this point, and as well as he had hoped.

The possibility of a downturn due to the effects of the steel adjustment seemed to have been removed. His general views about the economy were quite well summarized in the chart show.

At the moment, Mr. Mitchell did not see a threat to stability in the present and prospective rates of resource utilization. Therefore, he saw no basic reason for any further firming action on the part of the Committee at this time. Possibly there would be some disclosure when the Federal budget was presented that would provide a clue for action, but in the meantime he would supply reserves adequately and ungrudgingly to cover seasonal requirements reasonably related to the present level of GNP. He hoped that this course would be adequate to get through the rest of the year.

Mr. Mitchell said the requirement from the standpoint of the balance of payments was to contain inflation within the U.S. More should not be expected from monetary policy. If it was necessary to go beyond that, selective measures should be used; he would not want to take measures that would restrict the domestic economy generally. It seemed to him the information in the chart show suggested quite persuasively that the price rises that had taken place were not pervasive. They were not the type that resulted from excessive demand. For those who were worried about the money supply growth, he would point out that this year there

had been no change in turnover in New York, and little change in the other six main money centers. In this situation there was only one change that could occur--the money supply had to grow.

Mr. Mitchell agreed with Mr. Hayes that the rate pattern had been distorted for some time. He hoped that before too long these distortions could be more or less unraveled. But he would not like to see this done in a period when there were seasonal pressures on the whole rate structure. The Committee had lived with the distortions for a long time, and he hoped in the year ahead something could be done, but not right now. For that reason he would reject Mr. Irons' proposal, although he found it quite attractive in a way. Perhaps something of that kind should be done in January, if the Committee did not find it necessary to do something else, but he would reject such a course of action at this point, largely for the reasons Mr. Galusha had advanced.

Mr. Mitchell favored alternative A of the draft directives but proposed certain language changes. At the beginning of the first paragraph, he would say: "The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing a rate of expansion comparable to that of the third quarter despite the contractive effect of a reduction in steel inventories. Business sentiment continues optimistic and financial resources are in shorter supply." This

would call attention to the fact that the contractive effect of the steel inventory adjustment had been absorbed and the economy continued to grow at the same rate as before.

Mr. Daane commented that three weeks ago he was pretty well convinced that once the Treasury financing was out of the way the time had come for an overt move in System policy involving a change of 1/2 per cent in the discount rate and in Regulation Q ceilings coupled with some cushioning of the move, similar to last November, in terms of somewhat greater reserve availability initially.

His view had been premised on both economic and financial grounds. From the standpoint of the economy, the System had for several years been following--in his judgment appropriately--a relatively easy, or more or less passively accommodative, policy in order to provide the needed credit stimulus or support to increasing aggregate demand in the interest of achieving full employment and a sustainable expansion within the framework of relative price stability.

On the resource utilization side, and specifically the employment side--or more accurately the unemployment side--Mr. Daane now felt that, as had been publicly acknowledged by top Labor Department officials, the country was down to the hard core unemployment, or a composition of unemployment that might be relatively impervious to additions to total aggregate demand.

Further credit-stimulated additions to demand in current circumstances of close to capacity operation in terms of utilization of resources must inevitably risk accelerating a price upcreep--perhaps even upsweep--that he sensed was already in process.

Continuance of a no-change System policy risked overstimulating an investment boom rather than containing it in the interest of continuing a sustainable expansion. On that score, in reading the green book and in following the chart show this morning, he again was particularly impressed by three points which seemed to him to be central to a diagnosis of the present situation. First, business fixed investment plans for 1966, which were already buoyant, at 8 per cent above 1965, were practically certain to be revised upward if the general expansion continued. Second, if business investment outlays rose considerably faster than they were now projected to rise, there would likely be fairly severe pressures on capacity in the machinery industries. And third, if GNP rose much faster than it was now projected to rise, the "selectivity" that had been characterizing price increases might begin to disappear, if it was not already disappearing.

At some time further ahead--Mr. Daane hoped a long time ahead--the risks and dangers of a downturn in business investment were bound to be serious. And the severity of the problem at that time would depend directly on the degree of disproportion that had

been allowed to develop in the meantime between the rate of growth of capital expenditures and the general rate of growth of the economy. The degree of ease in monetary and credit policy would certainly be a major determining factor.

Parallel to the need for restraining credit expansion so as to help avoid an unsustainable acceleration in business investment, restraint was needed to damp down the growth in consumer expenditures financed by credit. Here again the need was for maintaining reasonable balance in the economy, and reasonable sustainability of rates of increase in the various flows of expenditure.

Above all, Mr. Daane said, it was necessary to restrain credit expansion so as to retain a reasonable degree of price stability. Whatever set of theories of linkages between credit or money and prices one might prefer, the present and prospective situation was certainly one in which too much ease would be likely to contribute, directly or indirectly, to upward pressures on prices. And if prices were to begin rising in a less selective manner than apparent up to now, the price rise in turn would feed the bullishness of the economy, stimulate protective inventory investment, and accelerate capital outlays--in short, lead into a classical boom completely unlike the steady well-balanced expansion that had existed for nearly five years now.

Last, but by no means least, on Mr. Daane's list of economic reasons for a System policy change was the deterioration in the U.S. balance of payments, which was not entirely papered over by changing definitions and strenuous Governmental efforts to achieve postponement of some scheduled outflows into next year's statistics. While the effect of a policy change might not produce immediately beneficial effects, it would clearly over time be supportive of the current efforts. Most importantly, it would contribute to the relative price stability essential to the eventual resolution of the balance of payments problem.

In sum, the case on economic grounds for a discount rate increase this December appeared to Mr. Daane to rest on the following:

1. Persisting gradual upward price pressures--with the wholesale price index rising at an annual rate of 1 per cent since June, following a 2 per cent rate of rise over the previous 9 months.
2. Continuing rapid expansion of business fixed investment at a pace disproportionate to the rise in final products--in the past 10 months, business equipment production was up 10 per cent; consumer goods production up 2 per cent.
3. A shrinking margin of unused resources--average manufacturing output at 90 per cent of capacity (and more in lines other than steel) and unemployment down to 2.9 per cent of adult males, with signs of a beginning slowdown of productivity and rise in unit labor cost.
4. A persisting balance of payments deficit--at roughly a $400 million per quarter rate on a regular transactions basis.

On the financial side, Mr. Daane said that three weeks ago he found the case for a change even more compelling. Both the demand and supply of funds seemed to be distorted by the continuance of relatively fixed rates in the banking sector and by the Committee's policy of seemingly resisting market forces in the interest of Treasury financing considerations. Today, financial developments still supplied support for a rate increase, although perhaps somewhat less support than a few weeks ago:

1. Credit demands were large and growing, especially business demands for external financing partly to pay for disproportionate expenditures on fixed investment.
2. Despite big business capital market flotations, and some bank efforts to push more borrowers into the capital markets, a stable 4-1/2 per cent prime loan rate kept drawing in business loan demands. To the extent that resultant demands taxed bank resources, resultant rationing actions pressed most against newer and smaller borrowers.
3. Seasonal pressures would be pushing up bill rates between now and mid-December--perhaps to in the neighborhood of 4.15 per cent on the 3-month bill. An accompanying seasonal tightening of other rates would increase pressures on discount administration and might trigger new disturbing uncertainties concerning discount rate action.
4. Higher short-term market rates would squeeze hard on bank ability to sell CD's to replace big December maturities. Such maturities were by now probably as big as September, when the post-tax-date squeeze pinched banks for several weeks and led to sharp rate run-ups.
5. Prime-name banks were already being led to merchandise promissory notes at shorter maturities and higher interest rates than allowable on CD's under Regulation Q. Unless Q ceilings were raised, promissory note issuance was likely to balloon in December, pushing up rates and complicating the Treasury's intended turn-of-year bill financing. If promissory notes were redefined as deposits to halt Regulation Q avoidance,

Q ceilings would have to be raised to give banks relief, and this would trigger renewed strong expectations of a discount rate increase--expectations that could inhibit market flows.

6. Higher interest rates could increase market capacity to handle flows, as had happened in the corporate market in the past two weeks. A higher discount rate could clear the air and improve the reception for unexpectedly large Treasury financing needs in January. That would be particularly true if at the same time open market operations reduced somewhat the need for member banks to borrow.

While Mr. Daane still felt the case could be made along the lines he had indicated, he was today less certain about the timing and sequence of System actions. It seemed to him the market was now poised precariously, having been buffeted by oral suasion and shifting expectations to the point where an overt move in the form of a discount rate change might set off a chain of over-reactions that could go far beyond the sort of modest tightening he had had in mind.

Thus, where he came out was that the Committee faced a choice of two courses. First, it could move back on net borrowed reserves to the high side of the $150 million mark and accept, not resist, market forces that in all likelihood would produce somewhat higher rates in the days and weeks ahead. Under that course he would at that point consider a change in the discount rate. To be specific, following that particular course at this juncture argued that it would be better for the System to follow than to lead the market. The alternative course was to go ahead with an overt move

on the discount rate as quickly as possible, with the cushioning action on reserves he had already suggested. Those two courses might not really be far apart in point of time, but his own preference would be, he believed, to follow rather than lead the market.

On the directive, Mr. Daane said that while philosophically he would favor alternative B of the draft directives, he could live with alternative A, provided somewhat firmer market conditions were restored along the lines he had advocated.

Mr. Maisel said he disagreed strongly with the first and last parts of Mr. Daane's analysis. He did, however, agree that there was a major problem in the likelihood of market over-reaction. He was pleased to see the feeling of both the Account Manager and the staff that this was a period of balance both in the economy and in the credit markets. The present situation was dangerous and worrisome because the economy was balanced at a high level of employment and output, but it was a very satisfactory level and one that he hoped could be maintained.

He did feel, Mr. Maisel continued, that a real danger of a sudden change in sentiment existed as a result of a misreading of the Committee's intent. This would cause the markets to react far more than anyone considered desirable.

It was fortunate at this time that a balance existed and that the Committee had an opportunity to wait and see. No change in policy was required. The main pressures appeared to be off with respect to the price-wage situation. The rising rate of increases in industrial commodity prices had slackened off. There was no indication of any acceleration of growth in the near term that would lead to a deterioration in wages or prices.

Even more important, Mr. Maisel added, was the fact that the country was now in the midst of a national emergency or war. Major industries had been asked, with no uncertainty in the request, to hold the price line. Without far stronger reasons than existed, a move on the System's part at this time to help raise the price of the major commodity it influenced--money--would be taken as a sign that banks wanted to opt out of the national effort and that the System approved of such action. This would directly contravene the Administration's request to labor, industry, and the banks to hold the line.

It seemed desirable to him to hold to present policy based on the actual price-wage situation, the national effort, and the need to maintain the present level in expectations and sentiment. The Manager should completely meet seasonal needs as they worked out in the market.

Mr. Maisel concluded by saying that he opposed a discount

rate change and that he supported alternative A of the draft directives.

Mr. Hickman said it seemed to him the Committee had little room to maneuver, even if it wanted to, insofar as policy action today was concerned. With the last Treasury financing of the year still in progress, it would be highly disruptive to change policy at this time, particularly since the new tax bills would have to be redistributed by the banks and dealers. Moreover, financial markets continued to be unstable, with the market for U.S. Government securities still highly sensitive to rumors and expectations.

So far as commodity prices were concerned, Mr. Hickman felt that the chance of serious price inflation was now greater than at any time in the past four years. But it could not be known that this would happen. For one thing, the standard price indexes, while drifting upward, had still not accelerated. For another, the increased capacity now coming on stream and the increase in the civilian labor force (barring unexpected draft calls) should reduce the likelihood of price inflation.

Insofar as overheating was concerned, Mr. Hickman believed the key question was the Federal budget. The normal revenue throw-off from an expanding GNP would permit a noninflationary rise in Federal spending for defense and the Great Society on the order of $5-$7 billion. On the other hand, a budgeted increase on a GNP

basis much beyond that would clearly be inflationary and should be offset by tighter money.

Even aside from the Treasury's current financing program, the situation thus came down to a matter of strategy and timing. With the budget now being drafted, the possibility of tighter money, and the assumed consequences, might be a major inducement to holding the Federal budget to a sustainable noninflationary level. As a matter of fact, he suspected that in this period of final budget decisions the fear of tighter money was a more effective policy instrument than the actuality would be.

Mr. Hickman therefore recommended no change in policy at this time, no change in the discount rate, and no change in Regulation Q. There were all sorts of technical problems to be handled between now and the next meeting. In dealing with them he hoped that the Manager would resolve doubts on the side of ease. He hoped also that the Manager would supply reserves through open market purchases whenever feasible rather than through repurchase agreements. He favored alternative A of the draft directives, amended along the lines suggested by Mr. Mitchell.

Mr. Bopp recalled having noted three weeks ago that it was becoming increasingly difficult for him to determine the appropriate stance for policy. Events since then and the outlook for the future certainly did not make the determination any easier.

Although the upcreep in prices had slowed and capacity limitations still did not appear to block further gains in output, many forecasts now emerging suggested a growth rate that could move the economy very close to full employment levels as 1966 unfolded. Before considering how monetary policy should react, however, it was necessary to recognize that the System was operating in a new environment of monetary, fiscal, and wage-price constraints. At present it was difficult to forecast how business would react to the more vigorous action on the guideposts and hence to determine precisely how monetary policy would fit into the new over-all mix of public policy.

Moreover, Mr. Bopp continued, the timing of any policy move must be weighed carefully. Financial markets were now under considerable pressure. In order to gain some insight into developing pressures, the Philadelphia Bank had taken a look at corporate sources and uses of funds and held discussions with treasurers of several large corporations in the Third District. In general, it was found that pressures prevailing in the corporate sector stemmed primarily from: (a) the normal seasonal increase in bond offerings at this time of year, (b) that increase superimposed upon a cyclical uptrend in credit demand, and (c) some marginal pressures resulting from anticipatory borrowing by firms which hoped thereby to assure availability of funds and avoid possible higher interest rates in the early months of 1966.

An examination of data on investment spending and cash flow in manufacturing suggested that, while investment spending tended to peak in the second and fourth quarters of the year, internally generated funds tended to be at a low ebb during these quarters, creating a seasonal squeeze on cash positions. Moreover, the squeeze currently coincided with what appeared to be a cyclical decline in the ratio of internally generated funds to total investment spending, creating further pressures for outside financing.

Those pressures were confirmed by many of the treasurers with whom he and his associates talked, Mr. Bopp said, individuals representing industries ranging from oils, chemicals, and instruments to steel, construction, public utilities, and transportation equipment. Well over half of the treasurers stated that internally generated funds were insufficent to meet current and projected spending plans and reported increased reliance on external financing. They reported that their needs for current and projected financing were primarily to meet firm spending commitments, though some suggested they were feeling pressure to acquire external funds now in anticipation of higher interest rates next year.

As Mr. Bopp saw conditions in financial markets, and as he appraised the new environment in which monetary policy must operate, he felt that this was not the time to tighten further. Also, considering that the first quarter of 1966 might be less buoyant

than some expected (with continuing steel inventory runoff, the social security tax bite, and a leveling in auto sales), he would be inclined to wait until seasonal pressures passed and a clearer outline of 1966 emerged before deciding whether additional monetary restraint was called for. He favored alternative A of the draft directives, with Mr. Mitchell's suggested modification.

Mr. Patterson said the Atlanta Reserve Bank's tabulation of announcements of new and expanded manufacturing plants indicated that half way through the fourth quarter the announcements of investments in that part of the country were already approaching the record third-quarter volume. This would fit in with the national McGraw-Hill findings, although the two series obviously were not comparable.

Having talked with some of the Sixth District's leading bankers, Mr. Patterson was more than ever convinced that liquidity had much deteriorated for banks generally, although he would agree that a bank-by-bank analysis was nece sary to determine over-all liquidity. District banks were relying on Federal funds more than ever. But there were limits to that supply, and some banks were becoming increasingly worried about what would happen if they had to tap that source simultaneously. Some Atlanta banks had started to issue small amounts of unsecured notes, primarily to test the market. With loan demand showing no signs of letting up and

Governments being used for collateral rather than liquidity purposes, Mr. Patterson had the uneasy feeling that banks were looking to the discount window as their source of liquidity. Resort to the discount window obviously should not be the banks' principal line of protection, and it was restricted in any case by the fact that banks held limited amounts of eligible assets. As bankers generally woke up to that state of affairs, he would expect them to react by restricting any rapid loan expansion.

Anticipating such self-tightening--which might already be taking place if changes in interest rates were any indication--Mr. Patterson believed that the System should not tighten its reins, at least for the time being. He would adopt alternative A of the draft directives.

Mr. Patterson added that, as he had already noted, some of the Sixth District's banks--cramped by the ceiling on CD rates--were beginning to solicit funds in a way that he considered subterfuge. Would it not be preferable, he asked, to allow banks to compete freely for time deposits? Personally, he would favor lifting the time deposit rate ceiling. And if that were done, he would be prepared to support some compensating open market operations and a technical change in the discount rate, because it was known from previous experience that a change in Regulation Q might lead to an acceleration in deposit expansion, which he would

consider unwarranted in the present economic climate. In terms of timing, he would be guided by those closer to the problems of the Treasury.

Mr. Shuford commented that the economy had passed through the steel inventory adjustment with business activity in general continuing to expand at a rapid pace. Industrial production, employment, and retail sales rose from September to October, maintaining the rapid rates of expansion that had prevailed since a year ago.

The recent rise in business activity appeared to be broadly based. Strength in business equipment and defense industries and in some consumer lines contributed to a high level of output and employment during the recent period of steel inventory adjustment. There had also been substantial increases of employment in trade, service, and State and local government. Now that the decline in steel output had halted, that sector of the economy should give added impetus to the present advance in business activity.

Fiscal and monetary developments had contributed to the current expansion, Mr. Shuford noted. The full employment budget surplus fell to about zero in the third quarter, and was expected to remain at that level in the fourth quarter. The surplus averaged $4.8 billion in 1964 and was running at a $6.7 billion annual rate in the first half of 1965. The money supply had

increased at a rapid 6.4 per cent rate since July and had risen 4.3 per cent over the past year. Both of those rates were high by historical standards.

Mr. Shuford thought the economy might be approaching the point where such a rapid expansion in aggregate demand as was occurring would result in less increase in real product and more price rises. The limiting factor might be labor resources rather than industrial plant capacity. The over-all unemployment rate now stood at 4.3 per cent and the rate for married men at 2.1 per cent; both rates were significantly lower than a year ago. Furthermore, expanded draft calls and increased college attendance would continue to impinge on the available supply of young workers. That group was among the most mobile of labor force participants and would normally be utilized in areas of labor shortages.

In Mr. Shuford's appraisal, prices had risen significantly during the past year. In view of the continued rapid increase in aggregate demand and a possible limit on the ability of production to match such an expansion, price increases might accelerate. There was a great deal of official concern with price increases, and that concern seemed to him to be well taken. But he was puzzled that the treatment most discussed and followed was administrative control.

It seemed to him the Committee should bear in mind that the economy had achieved advances in output and employment, at the expense of some price increases, through increasing total demand by means of fiscal and monetary stimulation. Whenever prices were rising as a result of market forces, that probably meant that total demand had been pushed up too rapidly and that containment of prices should depend primarily on some cutting back of demand by fiscal and monetary measures.

Taking into consideration the strength in total demand, which was exerting upward pressure on prices, as well as an apparent escalation of the U.S. commitment in Vietnam, which might add further to total demand, Mr. Shuford thought a tightening in monetary policy was desirable. He was not sure how this could best be accomplished. The problem of timing was always of concern, but he was persuaded that action should be taken promptly to raise the discount rate. He had been thinking in terms of a 1/2 per cent increase, but the analysis by Mr. Irons had much to support it. It seemed to him that a little further discussion on that score might be needed, and perhaps additional discussion on the matter of timing. But it occurred to him that hardly ever was a completely desirable time found for a move of this kind. He was not sure it would be any easier to reach a decision in January than in December. Since it was his opinion that action was needed,

he would favor moving without undue delay sometime in the first part of December.

Mr. Balderston commented that he thought the Committee was approaching a time of decision, which pleased him because of his belief that continued adherence to the status quo--in itself a decision of sorts--could lead to real trouble.

U.S. exports were still insufficient, even when supplemented by the return on foreign loans and investments, to cover U.S. outlays abroad, Mr. Balderston observed. The Government had failed to exert enough restraint upon its foreign spending (partly because it was embroiled in war) and U.S. corporations had not curbed sufficiently their direct foreign investing for equilibrium to be restored.

Clearly, U.S. export prices would have been even more competitive if more of U.S. gains in productivity had been applied to price reduction. Failure to restrain bank credit was frequently defended on the ground that wholesale prices had not risen very much, so efforts to prevent further advances would be premature. The point was that with magnificent productivity gains the nation had had the choice between wage advances and price reductions. If prices had fallen, U.S. export competitiveness would more nearly match U.S. political and military needs in foreign places. But failure to export enough caused dollar claims to accumulate month

after month in foreign hands, and in sufficient volume to embarrass the U.S. Despite selective controls and a plethora of promises, the loss of gold continued. It seemed imperative that ebullience not be permitted to boost prices and lose the competitive gains of the past few years.

Mr. Balderston's second point had to do with interest rate distortions and bank illiquidity. The distorted interest rate structure of the moment reflected the fact that the administered lending rates of banks were out of tune with the increased rates on open market paper. That distortion was pointed up by the acute pressure upon rates within the range, roughly, of 3 months to 3 years. Because the rate structure was out of balance, there were troublesome distortions in flows of funds and uses of financial instruments. Those included increasing bank reliance on high-rate promissory notes to raise funds because such notes circumvented the Regulation Q ceiling. This accentuated the problems of bank supervision because, on those notes, banks neither observed reserve requirements nor adhered to the rate ceiling.

Because banks had retained the 4-1/2 per cent prime rate as other interest rates rose, it had become a cut rate and had attracted business that otherwise would have gone to the capital markets. That additional business had come from large corporations

whose loan applications could not easily be turned down by banks on whose boards the heads of such corporations sat. Therefore, such credit restriction as banks had introduced tended to fall upon small and medium-sized concerns. Although banks would not admit to doing much credit rationing as yet, commercial finance companies reported increased applications from smaller businesses that claimed to have been discouraged at their banks.

The therapeutic action required to straighten out the unfortunate rate structure of the moment might well be an increase in the discount rate accompanied by a similar increase in Regulation Q ceilings. Mr. Balderston's concern about a 4-1/4 per cent discount rate, which on technical grounds might be defended, was that the market would be waiting for the other shoe to drop. Also, friends of the U.S. abroad, who had been hoping for many months to see strong, definite action taken by the monetary authorities, perhaps would be disappointed.

Mr. Balderston recalled that at the meeting of the Committee on October 12 he sought to state the case for re-examining current monetary policy. Among the points he had made at that time were the following: Wage pressures, combined with Government spending for war and welfare activities, suggested to businessmen that things would cost more later on. In addition, business forecasts for the coming year were favorable. As a result of those rising

expectations, both actual and projected plant investment volumes were strong. Thus business loan activity had been exceptionally heavy throughout the year, even though the current annual rate of increase in business loans was only one-half of the 20 per cent rate of increase for the first nine months, because long-term credit demands had been diverted from the open market to the banks.

The bind in which the bankers now found themselves would not have been so tight, Mr. Balderston commented, if the bankers had had the courage to utilize the pricing mechanism in guiding or forcing customers to secure their funds through channels appropriate to the use of the funds. But that did not happen, and now the Federal Reserve in its supervisory capacity faced the responsibility of remedying the chaotic rate structure. System action would have been more effective at an earlier date. But there had been a succession of Treasury financings, and it was probably better to act late than never. If the System acted--and there was not much time left before the next Treasury financing operation--the appropriate open market policy probably would be represented by alternative A of the draft directives. If the System did not act with respect to the discount rate and Regulation Q, then he would favor some other policy.

Mr. Shepardson remarked that the bulk of the criticism he had read of System policy over the past 10 years was to the

effect that the System usually moved too late. It was said that the System could not arrive quickly enough at a decision. It was too late to tighten, when tightening was appropriate, and too late to ease when that was appropriate. This, in his opinion, was one of the problems with which the System had to deal.

Chairman Martin commented that over the past two years he had been proud to preside over the Federal Reserve System because, despite continuing differences of opinion, the debates had been on a consistently high level. Having said this, he would also say that he considered it unfortunate that the System had been divided and continued to be divided. He had always felt that when the System was united it occupied a strong position within the ranks of the Government. When divided, the System was in a less strong position.

As long as a high level of unemployment prevailed and resource utilization was clearly below any reasonable level, he did not think there was too much trouble in debating the "easy money" and the "not-so-easy money" schools of thought, and that was fundamentally what the debate had been about over most of the past two years. The "easy money" school had thought that some moves the Committee made were mistakes, when the Committee made them, and he respected that view.

But, Chairman Martin said, he wanted to make his own point of view clear this morning. He thought the time for decision had arrived, and he wanted the record to reflect his opinion that it was not possible to run away continually from making a decision. It could be debated at length whether a situation of full employment existed and whether the resource utilization level was entirely adequate. It could also be debated whether a monetary policy move at this juncture would have any impact from the balance of payments standpoint. He happened to think that it would, and he had thought so for a good while, but this was certainly a debatable point. But to revert to the paper he had read at the October 12 meeting--and had discussed at high levels--he thought the financial problem was acute when conditions reached a point where, regardless of the decisions made by the Open Market Committee, it was necessary to support a Treasury financing operation in order to make it successful. While there might be some who would disagree with him, he did not think there was any doubt that except for official purchases for Treasury accounts and except for System support the latest offering of the Treasury would not have been successful.

Talk about market expectations, Chairman Martin noted, could work both ways. In the market today the expectations were just as much that the President would not allow any interest rate

changes as to the contrary. That created a very real problem. The Treasury expected to announce another financing on the 16th of December. Therefore, if the System was going to make any move now, it must do so before that time. He did think, however, that this week would be too early.

When it came to what to do, the Chairman remarked, there was clearly a difference of judgment around the table. Mr. Galusha had said that he was a bit uneasy, and he (Chairman Martin) also was uneasy. One could not know what construction would be placed on any move on the part of the System. In his own mind, there was no question about the strength of the economy. But there were all sorts of philosophies about how to handle the situation. There was the question of selective controls versus general controls. When one moved into a period like the present, a tendency developed for people to say they agreed on the need for some action, but to add that the problem should be handled entirely by selective controls. Nevertheless, the System did not have selective controls at its disposal, and whether one favored their use or not they were not likely to be available fast enough to be of any value. If the System waited until mid-January, and if the budget turned out as he thought it would, he believed it would be too late for monetary policy to have any effect on the course of events. There was quite a difference, admittedly, between interest rates and steel,

aluminum, or copper prices. But without arguing the wisdom, or lack of wisdom, on the part of the Administration in rolling back aluminum or copper prices, he thought that if one were going to roll back those prices because of a fear of inflation, one also ought, at the same time, to permit an adjustment of interest rates to restrain inflation. The two things were compatible--not incompatible--as operating techniques.

Chairman Martin observed that it was necessary to make fundamental judgments at this stage. It was easy for him to make a judgment because he believed the country was in a period of creeping inflation already. And he believed the balance of payments situation would be benefited by more restraint in the over-all economy. In short, he thought the economy was going too fast at the moment. This was where one came up against the basic problem--to which he did not know the answer--relating to the economics of full employment. Here there were different schools of thought. Personally he felt that t some point, if the economy went too fast, the possibility of achieving sustainable full employment would be destroyed. And he thought the situation was about at that point now.

Accordingly, he did not have any real difficulty with his line of approach. When it came to the implementation, though, he

would hesitate to move in the manner that he understood Messrs. Ellis and Daane were suggesting, that is, to pursue a firmer policy by reducing the level of reserves in the reservoir. He thought that the demand forces in the economy were so strong that even with a slight increase in the amount of reserves in the reservoir there would still be a rise in interest rates. Therefore, the Committee was in the relatively fortunate position of not having to tighten money per se.

The difficulty of the moment, the Chairman added, had been compounded by the banks' unwillingness to deal with their own problem; in his judgment they had let themselves become bound into the prime rate in a ridiculous way. But the situation had to be unraveled at some point. It could be unraveled by a decline in business, although he hoped it would not. The other way--the only way that he felt would be effective--would be to move on Regulation Q and the discount rate and to continue the level of reserves during the period of transition, or perhaps even to increase the level slightly during the period of transition so as to make the adjustment less difficult in terms of the over-all economy.

That was where he came out, Chairman Martin said. As to the directive, he thought the Committee probably could agree on alternative A and probably could not agree on alternative B. There seemed to be a clear majority in favor of alternative A.

In this framework, Chairman Martin continued, he would personally be prepared to approve a discount rate action, if taken by any Reserve Bank, prior to mid-December. To run too close to the next Treasury financing would, of course, be a mistake. He would expect, also, that if the Board approved a discount rate change it would make a change in the Regulation Q ceiling.

Chairman Martin commented additionally that it must be remembered that the Open Market Committee did not set the discount rate, just as it did not fix reserve requirements or margin requirements. The Committee meetings were used as a forum for discussion of System policy generally, but no commitment could be made with respect to the discount rate. The Board would have to act on that, and he could not anticipate how the Board would act. He had merely wanted to make it clear that for his part, as one member of the Board--and assuming a continuation of present conditions--if any Reserve Bank should come in with an increase in the discount rate he would be prepared to approve. He would not vote to approve, however, without an increase in the Regulation Q ceiling also. He was not suggesting that anyone act on the discount rate; he was merely expressing his present position and indicating how he would react, as one member of the Board, if such action were taken by a Reserve Bank.

Chairman Martin repeated that a majority of the Committee appeared to favor alternative A of the draft directives. He would be willing to go along with that directive himself. If, however, some members favored alternative B there was no reason why they should not so record themselves.

Mr. Daane asked the Manager whether alternative A meant to him a restoration of the degree of firmness that had prevailed prior to the aberrations of the recent period.

Mr. Holmes, in reply, referred to the diverse trends in various market indicators, even allowing for the aberrations of the past 3 weeks. At the moment, for example, he was looking at estimated net borrowed reserves of $200 million for the present statement week. Federal funds were now reported to be trading at 3-3/4 per cent, and the bill rate was unchanged. With this sort of mix in the figures, it was hard for him to say in advance exactly how the specific indicators were likely to develop.

Mr. Hayes said that he agreed with the Chairman on the directive and that he welcomed the Chairman's statement of position, with which he found himself in complete agreement. He also concurred with the comment of Mr. Shepardson about the tendency on the part of the System to be too late in reaching policy decisions, and with the Chairman's comment about the futility of trying to run away from decisions. As he listened to the comments around the

table, he had been impressed by the evident reluctance in some quarters to make use of one of the System's policy instruments--the discount rate--even recognizing that there were always some uncertainties in the market that might be exaggerated by such a move. He was impressed by the arguments of Mr. Daane, which to him were about as compelling arguments for a discount rate move as he had ever heard. As he understood Mr. Mitchell's comments, they implied that the choice was between no change in policy and favoring a reversal of the economy. Certainly no one would want to advocate a reversal of the economy. All that anyone was talking about was prevention of overheating. The fostering of stable economic growth did not mean that one favored a contraction of the economy. The difficulty he found in the suggestions of Messrs. Ellis and Daane was that he did not quite see how policy could be firmed in the open market area without immediately creating even more serious problems than now existed by virtue of the Regulation Q ceiling, which in turn was closely related to the discount rate itself. Mr. Daane had said that perhaps there was not much difference from the standpoint of timing between his two alternatives, and it seemed to Mr. Hayes that the System's latitude as to timing was distinctly limited. If a move was not made shortly, the Treasury financing schedule might preclude any action until late in February. Perhaps there would be some room in January,

but it was necessary to recognize the possibility that if no move was made in the next week or two, the System might be blocked out for a couple of months.

Mr. Mitchell commented that obviously there was not a man at the table who would admit wanting to turn the economy downward. However, there were those who wanted to take steps that in his opinion would lead to such an end. He agreed with Chairman Martin that many differences within the System's ranks related to questions of timing and degree, but there was another much more fundamental difference. This was the belief on the part of many that cyclical fluctuations were inevitable, that sooner or later what went up would have to come down. If one said the System usually did not act until too late, it was implicit in the analysis that if the economy rose, at some point it had to turn down. Mr. Mitchell said he recognized that there were many problems in keeping the economy moving forward at a sustainable rate of expansion. As Chairman Martin liked to say, it was a tough job. But he felt it was possible to go far beyond previous accomplishments in terms of continuing expansion. There had now been a period of expansion of almost 60 months, and he did not think one should assume that at the end of 60 months there would have to be a downturn. He would be more cautious than some in treating the condition of the economy and in doing anything that might upset the rate of expansion. This was the fundamental difference between his thinking

and that of some others. In most other respects, he thought the questions at issue might turn out to involve differences of judgment on the matter of timing.

Mr. Danne remarked that he had not been talking so much about a reduction in the reserve reservoir--to use the Chairman's figure of speech--as a containment of reserve availability within bounds. He was thinking specifically of net borrowed reserves somewhat above $150 million--a containment of the reservoir rather than a reduction. He thought that with the demands the market was likely to experience in the days ahead, this would produce a market that would be much more supportive of a rate change than today.

Mr. Maisel referred to the Chairman's comments about the situation having reached a stage where it was necessary to deal with the economics of full employment. He felt the situation required walking a tight rope that was admittedly hard to walk. He still hoped, however, that incomes policy, as opposed to monetary policy, would continue to be used at this point. In his judgment the Administration had properly been using incomes policy. If a change were made now to monetary policy, that would amount to giving up. It would amount to saying that the System did not favor the present way of handling national policy and therefore was going to use monetary policy. There were two basic points--how to walk the tightrope and whether to continue to walk it.

It should be clear that he felt that not changing interest rates was very definitely a part of the economics of full employment.

Chairman Martin commented that he did not think it was really a question of "either-or;" it was a question of "both."

Mr. Ellis said that just because one was concerned about the quality and structure of expansion, as well as the rate of expansion, this did not necessarily mean that he had a limited horizon on the length of the expansion. System action could be taken as reflecting concern about the conditions of expansion, rather than adoption of a view that a downturn was just ahead.

Referring to his earlier statement about putting on the brakes, Mr. Shepardson said that he perhaps misspoke. He did not mean to imply the imminence of or need for a turndown but rather a slowing of the rate of expansion to a more sustainable level. By way of analogy, he mentioned the situation of the Texas homebuilder desiring shade for his home. He might plant the fast-growing Chinaberry which would provide quick shade but which is short-lived and extremely brittle in a storm. Or he might plant live oaks which are slow-growing but long-lived and hardy and would provide shade for his children and grandchildren. His preference, Mr. Shepardson said, was for the live oak, and likewise, in this instance, for courses of policy that would promote longer-term economic growth, even though a somewhat less rapid pace of expansion might be involved.

Chairman Martin then alluded to the modification suggested earlier by Mr. Mitchell in the language of the first paragraph of alternative A of the draft directives, and he inquired as to the wishes of the Committee members. Mr. Hayes expressed a preference for the original language of the draft directive, particularly since he felt that the introduction of the phrase "financial resources were in shorter supply" was troublesome. Others who spoke on the matter indicated that they would be agreeable to the proposed modification except for the phrase to which Mr. Hayes had referred.

Thereupon, upon motion duly made and seconded, and by unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is continuing a rate of expansion comparable to that of the third quarter despite the contractive effect of a reduction in steel inventories. Business sentiment continues optimistic and financial conditions are firmer. Meanwhile, our international payments have remained in deficit. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall

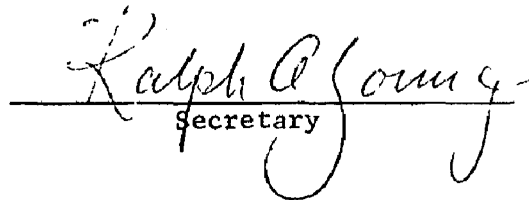
> be conducted with a view to maintaining about the same conditions in the money market that have prevailed since the last meeting of the Committee.

Mr. Shepardson commented, with respect to his vote on the directive, that he had not dissented from the adoption of this directive because of his view that the policy move he thought was needed could appropriately come in the form of a discount rate increase. Absent such an expectation, he would have favored alternative B of the draft directives.

Chairman Martin observed, in this connection, that he felt the views of the respective Committee members would be reflected adequately in their comments that would be included in the minutes of this meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 14, 1965, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR) November 22, 1965

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 23, 1965

Alternative A (no change)

The economic and financial developments reviewed at this meeting indicate that over-all domestic economic activity is expanding strongly in a continuing climate of optimistic business sentiment and firmer financial conditions. Meanwhile, our international payments have remained in deficit. In this situation, it remains the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to avoid the emergence of inflationary pressures, while accommodating moderate growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the same conditions in the money market that have prevailed since the last meeting of the Committee.

Alternative B (firmer)

The economic and financial developments reviewed at this meeting indicate strong further domestic economic expansion in a climate of optimistic business sentiment, with strong credit demand and some continuing upward creep in prices. Meanwhile, our international payments have remained in deficit. In this situation, it is the Federal Open Market Committee's current policy to strengthen the international position of the dollar, and to resist the emergence of inflationary pressures by moderating growth in the reserve base, bank credit, and the money supply.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving somewhat firmer conditions in the money market than have prevailed since the last meeting of the Committee.